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MORGAN STANLEY & CO. INTERNATIONAL plc

Half-yearly financial report

30 June 2012

MORGAN STANLEY & CO. INTERNATIONAL plc

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MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

The Directors present their interim management report and the condensed consolidated financial statements (“Interim Financial Statements”) of Morgan Stanley & Co. International plc (the “Company”) and all of its subsidiary and associated undertakings (together the “Group”), for the six month period ended 30 June 2012. This interim management report has been prepared for the Group as a whole and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiary and associated undertakings when viewed as a whole.

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

RESULTS AND DIVIDENDS

The Group’s profit for the six month period to 30 June 2012, after tax, is \$249 million (30 June 2011: \$252 million). No interim dividends were paid or declared (30 June 2011: \$nil).

PRINCIPAL ACTIVITY

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

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

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

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

BUSINESS REVIEW

During the six month period ended 30 June 2012, market and economic conditions improved modestly in the first quarter but were negatively impacted in the second quarter by renewed concerns about the deepening European sovereign debt crisis, lack of robust economic recovery in the United States (“US”) and slowing economic growth in emerging markets.

In Europe, real gross domestic product growth stabilised in the first quarter of 2012 but weakened in the second quarter of 2012. At 30 June 2012, major equity market indices in Europe were either higher or flat compared with the beginning of the year. However, for the second quarter of 2012, these indices were lower compared with the beginning of the quarter as investors’ concerns about the sovereign debt crisis, especially in Greece, Ireland, Italy, Portugal and Spain (the “European Peripherals”) and the sovereign debt exposures in the European banking system heightened. The euro-area unemployment rate increased to 11.2% at 30 June 2012 from 10.6% at 31 December 2011. In early July 2012, the European Central Bank (“ECB”) lowered the benchmark interest rate from 1.00% to 0.75% in order to stimulate economic activity in Europe. The Bank of England’s (“BOE”) benchmark interest rate was 0.5% and was unchanged from 31 December 2011.

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

To inject further monetary stimulus into the economy in the UK, the BOE increased the size of its quantitative easing program in the first quarter of 2012 and again in early July 2012. During the first six months of 2012, funding conditions for euro-area banks eased as the ECB conducted its second three-year refinancing operation and widened the pool of eligible collateral for refinancing operations. European Union leaders agreed on a new bailout and debt-restructuring agreement designed to reduce Greece's debt in February 2012 and reached another agreement to ease the recapitalisation of struggling European banks in late June 2012. In the first six months of 2012, several major rating agencies downgraded the credit ratings for some euro-zone countries and some European Union member countries such as Italy, the UK and Spain entered into a technical recession (two consecutive quarters of negative gross domestic product).

In response to the ongoing uncertainties in Europe the Group has significantly reduced its net exposure to European Peripherals. Details of the country risk exposures are provided on page 5 of the Interim Management Report.

The condensed consolidated income statement for the six month period to 30 June 2012 is set out on page 13. The Group's profit after tax for the six month period to 30 June 2012 decreased by \$3 million to \$249 million, a decrease of 1% compared to the six months period to 30 June 2011.

The Group's revenues are best reviewed across the aggregate of 'Net gains on financial instruments classified as held for trading', 'Net gains on financial instruments designated at fair value through profit or loss', 'Interest income', 'Interest expense' and 'Other income' ("aggregate revenues"). Aggregate revenues for the six month period ended 30 June 2012 declined by 3% to \$2,154 million compared to \$2,220 million for the six month period ended 30 June 2011.

Investment banking revenues during the six month period to 30 June 2012 were lower compared to the prior period to 30 June 2011, reflecting lower revenues from advisory and underwriting transactions.

Equity sales and trading revenues increased during the six month period to 30 June 2012 compared to the prior period to 30 June 2011 reflecting higher revenues in the derivatives business, and the accrual for expected reimbursement from clients on certain equity transactions. This was however, partially offset by lower revenues in core and portfolio equity products, as well as negative revenues related to changes in the fair value of net derivative contracts attributable to the tightening of Morgan Stanley's credit default swap spreads.

Revenues within fixed income sales and trading increased during the six month period to 30 June 2012 compared to the prior period to 30 June 2011, reflecting higher revenues across interest rate and currency products, credit corporate products and commodities products, partially offset by reduced revenues in securitised products and credit derivative products. The results also include negative revenues due to the impact of the tightening of Morgan Stanley's debt-related credit spreads on borrowings that are measured at fair value.

Aggregate revenues for the six month period ended 30 June 2012 exclude net day one gains of \$74 million not recognised upon initial recognition of financial instruments measured at fair value where valuation techniques include unobservable market data (six month period to 30 June 2011: \$239 million gain). In addition, aggregate revenues include a charge of \$82 million representing derivative credit valuation allowances related to additional collateral requirements.

Other expenses have decreased from \$1,797 million for the six months ended 30 June 2011, to \$1,655 million for the six month period ended 30 June 2012 driven by a decrease in staff costs attributed to a reduction in discretionary compensation.

The Group's effective tax rate for the six month period ended 30 June 2012 was 50% compared to 40% for the six month period ended 30 June 2011. Further details are provided in note 3 of the Interim Financial Statements.

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

The condensed consolidated statement of financial position presented on page 17 reflects increases in the Group's total assets and total liabilities of \$22,608 million and \$22,336 million respectively, an increase of 4% as at 30 June 2012 when compared to 31 December 2011. The increase in total assets is driven by increases in trade receivables and reverse repurchase agreements, offset by a reduction in financial assets held for trading. The increase in total liabilities is driven by an increase in trade payables offset by a decrease in financial liabilities held for trading. The increase in trade receivables and trade payables is attributed to increased trading activity. The decrease in financial assets and liabilities held for trading during the period is driven by decreases in derivative assets and derivative liabilities as a result of client activity and fair value movements.

The condensed consolidated statement of cash flows presented on page 18 shows a net increase in cash of \$581 million during the six month period to 30 June 2012 (six month period to 30 June 2011: net increase of \$4,322 million), driven by \$654 million cash generated from operating activities (six month period to 30 June 2011: \$4,383 million), partially offset by \$71 million interest paid on subordinated debt (six month period to 30 June 2011: \$61 million). Excluding segregated client funds, the net increase in cash for the six month period to 30 June 2012 was \$1,886 million (six month period to 30 June 2011: net increase of \$3,019 million).

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

Risk management

Risk is an inherent part of both Morgan Stanley's and the Group's business activity and is managed by the Group within the context of the broader Morgan Stanley Group's business activities. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its activities on a global basis, in accordance with defined policies and procedures and in consideration of the individual legal entities. The Group's own risk management policies and procedures are consistent with those of the Morgan Stanley Group. Note 7 to the Interim Financial Statements provides qualitative and quantitative disclosures about the Group's management and exposure to financial risks.

Credit risk

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

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

Country risk exposure

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

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INTERIM MANAGEMENT REPORT

Risk management (continued)

Country risk exposure (continued)

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

The Group's country risk exposure, including the effect of the risk mitigants as at 30 June 2012 is shown across the following two tables. The basis for determining the domicile of the exposure is based on the country of jurisdiction for the obligor or guarantor, factors such as physical location of operations or assets, location and source of cash flows/revenues, and location of collateral (if applicable). Credit Default Swaps ("CDSs") are incorporated in the exposure where protection is both purchased and sold.

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

Select European Countries

In connection with certain of its Institutional Securities business segment activities, the Group has country risk exposure to many foreign countries. During the six month period ended 30 June 2012, the European Peripherals and France continued to experience varying degrees of credit deterioration due to weaknesses in their economic and fiscal situations.

The following table shows the Group's country risk exposure to European Peripherals and France at 30 June 2012. The majority of the financial instruments included in the table below are classified as held for trading and are measured at fair value or are collateralised borrowings or lendings. As a result, the Group does not have any recognised impairment on the financial instruments included in its country risk exposure to European Peripherals and France. Exposure to other Morgan Stanley Group undertakings has been excluded from the table below.

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INTERIM MANAGEMENT REPORT

Risk management (continued)

Select European Countries (continued)

Country Risk Exposure to European Peripherals and France

Country	Net Inventory(1) \$millions	Net Counterparty Exposure(2) \$millions	Unfunded Lending \$millions	CDS Adjustments(3) \$millions	Exposure Before Hedges \$millions	Hedges(4) \$millions	Net Exposure \$millions
Greece:							
Sovereigns	24	-	-	-	24	-	24
Non-sovereigns	18	-	-	-	18	(1)	17
Total Greece	42	-	-	-	42	(1)	41
Ireland:							
Sovereigns	30	1	-	4	35	-	35
Non-sovereigns	129	41	-	1	171	-	171
Total Ireland	159	42	-	5	206	-	206
Italy:							
Sovereigns	(981)	278	-	136	(567)	(138)	(705)
Non-sovereigns	23	417	14	66	520	(200)	320
Total Italy	(958)	695	14	202	(47)	(338)	(385)
Spain:							
Sovereigns	(238)	11	-	497	270	(64)	206
Non-sovereigns	134	455	90	133	812	(129)	683
Total Spain	(104)	466	90	630	1,082	(193)	889
Portugal:							
Sovereigns	(276)	29	-	26	(221)	(102)	(323)
Non-sovereigns	(42)	33	-	23	14	(46)	(32)
Total Portugal	(318)	62	-	49	(207)	(148)	(355)
Sovereigns	(1,441)	319	-	663	(459)	(304)	(763)
Non-sovereigns	262	946	104	223	1,535	(376)	1,159
Total European Peripherals	(1,179)	1,265	104	886	1,076	(680)	396
France:							
Sovereigns	(707)	237	-	-	(470)	(23)	(493)
Non-sovereigns	(528)	1,647	564	10	1,693	(436)	1,257
Total France	(1,235)	1,884	564	10	1,223	(459)	764

- (1) Net inventory representing exposure to both long and short single name positions (i.e., bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).
- (2) Net counterparty exposure (i.e., repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.
- (3) CDS adjustment represents credit protection purchased from European peripheral banks on European peripheral sovereign and financial institution risk, or French banks on French sovereign and financial institution risk. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (4) Represents CDS hedges on net counterparty exposure and unfunded lending. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (5) In addition, as at 30 June 2012, the Group had European Peripherals and French exposure for overnight deposits with banks of approximately \$0.1 million and \$15.9 million, respectively.

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INTERIM MANAGEMENT REPORT

Risk management (continued)

Non-UK country risk exposure

The following table shows the Group's significant non-UK country risk exposure at 30 June 2012, excluding select European countries disclosed above. Exposure to other Morgan Stanley Group undertakings has been excluded from the table below.

Country	Net Inventory(1) \$millions	Net Counterparty Exposure(2) \$millions	Net Exposure Before Hedges \$millions	Hedges(3) \$millions	Net Exposure \$millions
Germany:					
Sovereigns	2,314	117	2,431	(686)	1,745
Non-sovereigns	(413)	1,731	1,318	6	1,324
Total Germany	1,901	1,848	3,749	(680)	3,069
Netherlands:					
Sovereigns	(97)	5	(92)	(227)	(319)
Non-sovereigns	53	1,261	1,314	(65)	1,249
Total Netherlands	(44)	1,266	1,222	(292)	930
China:					
Sovereigns	85	316	401	-	401
Non-sovereigns	212	201	413	(48)	365
Total China	297	517	814	(48)	766
Japan:					
Sovereigns	(175)	-	(175)	-	(175)
Non-sovereigns	187	706	893	-	893
Total Japan	12	706	718	-	718
Republic of Korea:					
Sovereigns	(15)	35	20	-	20
Non-sovereigns	169	425	594	(5)	589
Total Republic of Korea	154	460	614	(5)	609

- (1) Net inventory representing exposure to both long and short single name positions (i.e., bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).
- (2) Net counterparty exposure (i.e., repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.
- (3) Represents CDS hedges on net counterparty exposure and unfunded lending. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (4) In addition, as at 30 June 2012, the group had exposure to these countries for overnight deposits with banks of approximately \$978 million.

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INTERIM MANAGEMENT REPORT

Risk management (continued)

Liquidity and capital resources

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

Morgan Stanley Group continues to actively manage its capital and liquidity position to ensure adequate resources are available to support the activities of the Morgan Stanley Group, to enable the Morgan Stanley Group to withstand market stresses, and to meet regulatory stress testing requirements proposed by regulators globally.

At 30 June 2012, the Group maintained sufficient liquidity to meet current and contingent funding obligations as modelled in its Liquidity Stress Tests.

During the period the Group complied with all regulatory capital requirements, ensuring sufficient Capital Resources were held.

Credit ratings

The Morgan Stanley Group relies on external sources to finance a significant portion of its day-to-day operations. The cost and availability of financing generally is impacted by the Morgan Stanley Group's credit ratings. In addition, the Company and Morgan Stanley's credit ratings can have an impact on certain trading revenues, particularly in those businesses where longer-term counterparty performance is a key consideration, such as OTC derivative transactions, including credit derivatives and interest rate swaps. Issuer specific factors that are important to the determination of the Company and Morgan Stanley's credit ratings include governance, the level and quality of earnings, capital adequacy, funding and liquidity, risk appetite and management, asset quality, strategic direction and business mix. Additionally, the agencies look at other industry-wide factors such as regulatory or legislative changes, macro-economic environment, and perceived levels of government support.

On 21 June 2012, Moody's Investors Service ("Moody's") downgraded the ratings of 15 banks on review for downgrade in the context of a broad review of global banks with capital markets operations. The Company and Morgan Stanley's long- and short-term debt ratings were lowered two notches to Baa1/P-2 from A2/P-1.

As at 31 July 2012, the Company and Morgan Stanley's credit ratings were as set forth below.

	<u>Company</u>			<u>Morgan Stanley</u>		
	<u>Short-term Debt</u>	<u>Long-term Debt</u>	<u>Rating Outlook</u>	<u>Short-term Debt</u>	<u>Long-term Debt</u>	<u>Rating Outlook</u>
Fitch Ratings	-	-	-	F1	A	Stable
Moody's Investor Services, Inc.	P-2	Baa1	Stable	P-2	Baa1	Negative
Rating and Investment Information, Inc.(1)	-	-	-	a-1	A	Negative
Standard & Poor's	A-1	A	Negative	A-2	A-	Negative

(1) On 14 May 2012, Ratings and Investment Information, Inc. downgraded Morgan Stanley's long-term rating one notch from A+ to A.

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INTERIM MANAGEMENT REPORT

Risk management (continued)

Credit ratings (continued)

As a result of the Moody's downgrade, the amount of additional collateral requirements or other payments that could be called by counterparties, exchanges or clearing organisations under the terms of certain OTC trading agreements and certain other agreements for the Group was approximately \$2,216 million. Of this amount, \$1,210 million was called and posted by the Group as at 30 June 2012. As of 31 July 2012, an additional \$448 million of collateral was called and posted, resulting in a total outflow of cash collateral for the Group of \$1,658 million since the 21 June 2012 downgrade. During the six month period, the Group incurred period specific charges of approximately \$82 million representing derivative credit valuation allowances related to additional collateral requirements, which have been reported within "Net gains on financial instruments classified as held for trading" in the condensed consolidated income statement.

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

Market risk

Market risk refers to the exposure of the Group to adverse changes in the values of its portfolios and financial instruments due to changes in market prices or rates. Generally, the Group is exposed to market risk as a result of trading, investing and client facilitation activities, mainly within the Institutional Securities business segment where the substantial majority of the Group's Value-at-Risk ("VaR") for market risk exposures is generated. The Group uses VaR as one of a range of risk management tools.

During the six month period to 30 June 2012 the Group has seen the average VaR for the Primary Risk Categories decline from an average of \$43 million in the year to 31 December 2011, to \$33 million in the six month period to 30 June 2012. This has been driven by reduced risk taking in fixed income products. The credit portfolio VaR has decreased on an average basis from \$21 million in the year to 31 December 2011, to \$17 million in the six month period to 30 June 2012, primarily due to reduced counterparty exposure during the period.

Operational risk

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

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

Risk management (continued)

Operational risk (continued)

The Group's operations rely on the secure processing, storage and transmission of confidential and other information in its computer systems and may be vulnerable to unauthorised access, mishandling or misuse, computer viruses and other events that could have a security impact on such systems. If one or more of such events occur, this potentially could jeopardise the Group's or the Group's clients' or counterparties' personal, confidential, proprietary or other information processed and stored in, and transmitted through, the Group's computer systems. Furthermore, such events could cause interruptions or malfunctions in the operations of the Group, its clients, its counterparties or third parties, which could result in reputational damage, litigation or regulatory fines or penalties not covered by insurance maintained by the Group, or otherwise adversely affect the business, financial condition or results of operations.

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

The Morgan Stanley Group continues to operate its Eurozone Crisis Planning Group to formulate strategy, planning and execution associated with the European sovereign debt crisis and focus on the associated legal and operational issues. This planning group has directed a number of focused risk management reviews to ensure the Morgan Stanley Group is prepared in the case of a Eurozone country default or exit.

Legal and regulatory risk

Legal and regulatory risk includes the risk of exposure to fines, penalties, judgements, damages and / or settlements in conjunction with regulatory or legal actions as a result of non-compliance with applicable legal or regulatory requirements or litigation. Legal risk also includes contractual risk such as the risk that a counterparty's performance obligations will be unenforceable. In the current environment of rapid and possibly transformational regulatory change, the Morgan Stanley Group also views regulatory change as a component of legal risk.

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

Significant changes in the way that major financial services institutions are regulated are occurring in the UK, Europe, the US and worldwide. The reforms being discussed and, in some cases, already implemented, include several that contemplate comprehensive restructuring of the regulation of the financial services industry. Such measures will likely lead to stricter regulation of financial institutions generally, and heightened prudential requirements for systemically important firms in particular. Such measures could include reforms of the OTC derivatives markets, such as mandated exchange trading and clearing, position limits, margin, capital and registration requirements. Changes in tax legislation in the UK and worldwide, such as taxation of financial transactions, liabilities and employee compensation, are also possible. Many of these changes, if enacted, may materially affect the Group's and the Morgan Stanley Group's business, financial condition, results of operations and cash flows in the future.

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INTERIM MANAGEMENT REPORT

Continuing market uncertainty

During the six month period to 30 June 2012 the Group has been exposed to the deteriorating economic and financial conditions in selected Eurozone countries. Although there has been a significant reduction in the Group's net exposure to certain Eurozone countries, there is still the risk of sovereign defaults, including contagion risk, and potential for the economic environment to worsen. The Morgan Stanley Group regularly performs stress testing to ensure both the Morgan Stanley Group and the Group have sufficient resources at their disposal to absorb losses associated with certain stressed scenarios. The global regulatory environment is continually changing and it remains difficult to assess the full impact on the Group. It is likely that there will be further material changes in the way major financial institutions are regulated and the impact of these changes are continually assessed.

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

Going Concern

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

As explained in previous pages, the impact of the Group's credit rating downgrade is not considered to have a material impact on its liquidity and funding position.

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

Approved by the Board and signed on its behalf by

A handwritten signature in blue ink, appearing to be 'C. BRYCE', is written over a light blue rectangular background.

Director

28 August 2012

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' RESPONSIBILITY STATEMENT

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

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

By order of the Board on 28 August 2012

A handwritten signature in black ink, consisting of a large, stylized 'C' followed by the name 'C. BRYCE' in capital letters.

Director

Board of Directors:

P Bailas

C Bryce

C Kelleher

F Petitgas

I Plenderleith

R Rooney

D Russell

C Woodman

INDEPENDENT REVIEW REPORT TO MORGAN STANLEY & CO. INTERNATIONAL plc

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six month period ended 30 June 2012 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated statement of changes in equity, the condensed consolidated statement of financial position, the condensed consolidated statement of cash flows and related notes 1 to 11. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Company in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*" issued by the Auditing Practices Board. Our work has been undertaken so that we might state to the Company those matters we are required to state to them in an independent review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company, for our review work, for this report, or for the conclusions we have formed.

Directors' responsibilities

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

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

Our responsibility

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

Scope of review

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

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six month period ended 30 June 2012 is not prepared, in all material aspects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.



Deloitte LLP
Chartered Accountants and Statutory Auditor
London
28 August 2012

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED INCOME STATEMENT Six months ended 30 June 2012

		Six months ended 30 June 2012 \$millions (unaudited)	Six months ended 30 June 2011 \$millions (unaudited)
Net gains on financial instruments classified as held for trading		1,985	2,061
Net gains on financial instruments designated at fair value through profit or loss		151	41
Interest income		1,402	2,314
Interest expense		(1,700)	(2,340)
Other income	2	316	144
Other expense		(1,655)	(1,797)
PROFIT BEFORE TAX		<u>499</u>	<u>423</u>
Income tax expense	3	(250)	(171)
PROFIT FOR THE PERIOD		<u>249</u>	<u>252</u>
Attributable to:			
Equity holders of the Company		248	251
Non-controlling interests		1	1
PROFIT FOR THE PERIOD		<u>249</u>	<u>252</u>

All operations were continuing in the current and prior periods.

The notes on pages 19 to 52 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc**CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE
INCOME****Six months ended 30 June 2012**

	Six months ended 30 June 2012 \$millions (unaudited)	Six months ended 30 June 2011 \$millions (unaudited)
PROFIT FOR THE PERIOD	<u>249</u>	<u>252</u>
OTHER COMPREHENSIVE INCOME		
Currency translation reserve:		
Foreign currency translation differences arising on foreign operations during the period	1	70
Fair value reserve:		
<i>Available-for-sale financial assets:</i>		
Net change in fair value recognised directly in equity	28	7
Income tax relating to components of other comprehensive income	(6)	(9)
OTHER COMPREHENSIVE INCOME AFTER INCOME TAX	<u>23</u>	<u>68</u>
TOTAL COMPREHENSIVE INCOME	<u><u>272</u></u>	<u><u>320</u></u>
Attributable to:		
Equity holders of the Company	273	313
Non-controlling interests	(1)	7
TOTAL COMPREHENSIVE INCOME	<u><u>272</u></u>	<u><u>320</u></u>

The notes on pages 19 to 52 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
Six months ended 30 June 2012

	Share capital \$millions	Share premium \$millions	Currency translation reserve \$millions	Capital redemption reserve \$millions	Capital contribution reserve \$millions	Fair value reserve \$millions	Retained earnings \$millions	Equity attributable to equity holders of the Company \$millions	Non- controlling interest \$millions	Total equity \$millions
2012										
Balance at 1 January 2012	9,464	513	(157)	1,399	3	16	2,169	13,407	71	13,478
Profit for the period	-	-	-	-	-	-	248	248	1	249
Other comprehensive income:										
Foreign currency translation differences on foreign operations	-	-	3	-	-	-	-	3	(2)	1
Foreign currency reclassification on liquidation of subsidiaries	-	-	(13)	-	-	-	13	-	-	-
Net change in fair value of available- for-sale assets recognised directly in equity	-	-	-	-	-	28	-	28	-	28
Income tax relating to components of other comprehensive income	-	-	-	-	-	(6)	-	(6)	-	(6)
Total comprehensive income	-	-	(10)	-	-	22	261	273	(1)	272
Balance at 30 June 2012	9,464	513	(167)	1,399	3	38	2,430	13,680	70	13,750

The notes on pages 19 to 52 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
Six months ended 30 June 2012

	Share capital \$millions	Share premium \$millions	Currency translation reserve \$millions	Capital redemption reserve \$millions	Capital contribution reserve \$millions	Fair value reserve \$millions	Retained earnings \$millions	Equity attributable to equity holders of the Company \$millions	Non- controlling interest \$millions	Total equity \$millions
2011										
Balance at 1 January 2011	5,578	513	(149)	1,399	3	(2)	1,716	9,058	73	9,131
Profit for the period	-	-	-	-	-	-	251	251	1	252
Other comprehensive income:										
Foreign currency translation differences on foreign operations	-	-	64	-	-	-	-	64	6	70
Net change in fair value of available-for-sale assets recognised directly in equity	-	-	-	-	-	7	-	7	-	7
Income tax relating to components of other comprehensive income	-	-	(7)	-	-	(2)	-	(9)	-	(9)
Total comprehensive income	-	-	57	-	-	5	251	313	7	320
Balance at 30 June 2011	5,578	513	(92)	1,399	3	3	1,967	9,371	80	9,451

The notes on pages 19 to 52 form an integral part of the Interim Financial Statements.

CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION
As at 30 June 2012

	Note	30 June 2012 \$millions (unaudited)	31 December 2011 \$millions
ASSETS			
Loans and receivables:			
Cash at bank		11,772	11,180
Securities borrowed		31,852	29,575
Reverse repurchase agreements		109,497	97,218
Trade receivables		96,603	67,371
Other receivables		6,031	7,225
		<u>255,755</u>	<u>212,569</u>
Financial assets classified as held for trading (of which approximately \$25,413 million (2011: \$33,132 million) were pledged to various parties)	4	335,087	354,143
Financial assets designated at fair value through profit or loss		7,137	8,562
Available-for-sale financial assets		97	67
Current tax		18	145
Deferred tax assets		39	44
Prepayments and accrued income		51	45
Property, plant and equipment		9	10
TOTAL ASSETS		<u><u>598,193</u></u>	<u><u>575,585</u></u>
LIABILITIES AND EQUITY			
Financial liabilities at amortised cost:			
Bank loans and overdrafts		213	124
Securities loaned		29,632	26,016
Repurchase agreements		79,086	76,904
Trade payables		106,894	83,626
Other payables		22,544	21,707
Subordinated loans		7,906	7,906
		<u>246,275</u>	<u>216,283</u>
Financial liabilities classified as held for trading	4	326,522	333,825
Financial liabilities designated at fair value through profit or loss		11,296	11,710
Provisions		6	10
Current tax		127	68
Deferred tax liabilities		12	7
Accruals and deferred income		201	200
Retirement benefit obligations		4	4
TOTAL LIABILITIES		<u><u>584,443</u></u>	<u><u>562,107</u></u>
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY			
Share capital		9,464	9,464
Share premium account		513	513
Other reserves		1,273	1,261
Retained earnings		2,430	2,169
		<u>13,680</u>	<u>13,407</u>
Non-controlling interest		70	71
TOTAL EQUITY		<u><u>13,750</u></u>	<u><u>13,478</u></u>
TOTAL LIABILITIES AND EQUITY		<u><u>598,193</u></u>	<u><u>575,585</u></u>

The notes on pages 19 to 52 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

As at 30 June 2012

	Note	Six months ended 30 June 2012 \$millions (unaudited)	Six months ended 30 June 2011 \$millions (unaudited)
NET CASH FLOWS FROM OPERATING ACTIVITIES	5(b)	654	4,383
INVESTING ACTIVITIES			
Purchase of available-for-sale financial assets		(2)	-
NET CASH FLOWS FROM INVESTING ACTIVITIES		<u>(2)</u>	<u>-</u>
FINANCING ACTIVITIES			
Interest paid on subordinated loans		(71)	(61)
NET CASH FLOWS FROM FINANCING ACTIVITIES		<u>(71)</u>	<u>(61)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS		581	4,322
Currency translation differences on foreign currency cash balances		(78)	306
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD		<u>11,056</u>	<u>10,376</u>
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	5(a)	<u><u>11,559</u></u>	<u><u>15,004</u></u>

The notes on pages 19 to 52 form an integral part of the Interim Financial Statements.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2012

1. BASIS OF PREPARATION

a. General information

The information in this interim report does not constitute statutory accounts within the meaning of Section 435 of the United Kingdom Companies Act 2006 (“Companies Act”).

The comparative information for the year ended 31 December 2011 does not constitute statutory accounts as defined in section 434 of the Companies Act. A copy of the statutory accounts for that year has been delivered to the Registrar of Companies. The auditor’s report on those accounts was not qualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying the report and did not contain statements under section 498(2) or (3) of the Companies Act.

b. Accounting policies

The Group prepares its annual financial statements in accordance with IFRSs issued by the International Accounting Standards Board (“IASB”) as adopted by the European Union (“EU”), Interpretations issued by the IFRS Interpretations Committee (“IFRIC”) and the Companies Act. The Interim Financial Statements have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority and in accordance with IAS 34 ‘*Interim Financial Reporting*’, as adopted by the EU.

In preparing these Interim Financial Statements the Group has applied consistently the accounting policies and methods of computation used in the Group’s annual financial statements for the year ended 31 December 2011.

New standards and interpretations not yet adopted

At the date of authorisation of these Interim Financial Statements, the following standards relevant to the Group’s operations were issued by the IASB but not yet mandatory. Except where otherwise stated, the Group does not expect that the adoption of the following standards will have a material impact on the Interim Financial Statements.

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

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

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

IAS 27 ‘*Consolidated and separate financial statements*’ and IAS 28 ‘*Investment in associates and joint ventures*’ were revised by the IASB in May 2011, for application in annual periods beginning on or after 1 January 2013.

An amendment to IAS 32 ‘*Financial instruments: presentation – offsetting financial instruments*’ was issued by the IASB in December 2011, for retrospective application in annual periods beginning on or after 1 January 2014.

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

1. BASIS OF PREPARATION (CONTINUED)

b. Accounting policies (continued)

New standards and interpretations not yet adopted (continued)

IFRS 10 '*Consolidated financial statements*', IFRS 11 '*Joint arrangements*' and IFRS 12 '*Disclosure of interests in other entities*' were issued by the IASB in May 2011 for retrospective application in annual periods beginning on or after 1 January 2013.

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

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

c. Use of estimates and sources of uncertainty

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

2. OTHER INCOME

Other income includes \$148 million representing the expected reimbursement from clients on certain equity transactions. Contractually the clients are bound to reimburse the Group for any tax, levy, impost duty, charge, assessment or fee, directly or indirectly, in connection with or arising from these equity transactions.

3. TAX EXPENSE

The Group's tax expense has been accrued based on the expected tax rate of 50% for the six month period to 30 June 2012 (30 June 2011: 40%). This takes into account current expectations concerning allocation of group relief within the Morgan Stanley UK tax group and prevailing tax rates in the jurisdictions in which the Group operates.

Within the current tax expense of \$250 million for the six month period to 30 June 2012 is an amount of \$142 million that represents a potential non-UK capital gains tax liability that may arise on equity investments made by the Group to hedge client positions.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

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

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

	30 June 2012	30 June 2012	31 December 2011	31 December 2011
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
Fair value				
Government debt securities	13,058	14,688	9,249	10,193
Corporate equities	18,108	18,410	22,282	14,762
Corporate and other debt	9,718	2,425	12,474	2,727
Derivatives	294,203	290,999	310,138	306,143
	<u>335,087</u>	<u>326,522</u>	<u>354,143</u>	<u>333,825</u>

5. ADDITIONAL CASH FLOW INFORMATION

a. Cash and cash equivalents

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

	30 June 2012 \$millions	30 June 2011 \$millions
Cash at bank	11,772	15,302
Bank loans and overdrafts	(213)	(298)
	<u>11,559</u>	<u>15,004</u>

Included within 'Cash at bank' is \$7,862 million (30 June 2011: \$9,167 million) of segregated client funds that are not available for use by the Group. The corresponding payable is recognised and included in 'financial liabilities at amortised cost'.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2012

5. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)

b. Reconciliation of cash flows from operating activities

	Six months ended 30 June 2012 \$millions	Six months ended 30 June 2011 \$millions
Profit for the period	249	252
Adjustments for:		
Depreciation on property, plant and equipment	2	1
Interest income	(1,402)	(2,314)
Interest expense	1,700	2,340
Income tax expense	250	171
Operating cash flows before changes in operating assets and liabilities	<u>799</u>	<u>450</u>
Change in operating assets		
Net increase in loans and receivables	(42,289)	(8,690)
Net decrease/(increase) in financial assets classified as held for trading	19,055	(38,685)
Net decrease/(increase) in financial assets designated at fair value through profit or loss	1,425	(1,401)
	<u>(21,809)</u>	<u>(48,776)</u>
Change in operating liabilities		
Net increase in financial liabilities at amortised cost	29,415	26,981
Net (decrease)/increase in financial liabilities classified as held for trading	(7,304)	25,473
Net (decrease)/increase in financial liabilities designated at fair value through profit or loss	(413)	543
Net decrease in provisions	(3)	(9)
	<u>21,695</u>	<u>52,988</u>
Effect of foreign exchange movements	80	(245)
Cash from operating activities	<u>765</u>	<u>4,417</u>
Interest received	1,089	2,124
Interest paid	(1,139)	(1,924)
Income taxes paid	(61)	(234)
Net cash flows from operating activities	<u><u>654</u></u>	<u><u>4,383</u></u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

6. SEGMENT REPORTING

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

Business segments

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

The Group has one reportable business segment, Institutional Securities, which includes the following activities: capital raising, financial advisory services; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities.

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

Condensed consolidated income statement information	Institutional Securities	Other	Total
Six months ended 30 June 2012	\$millions	\$millions	\$millions
Net gains on financial instruments classified as held for trading	1,960	25	1,985
Net gains on financial instruments designated at fair value through profit or loss	151	-	151
Net interest (expense) / income	(308)	10	(298)
Other income	311	5	316
External revenues	2,114	40	2,154
Other expense	(1,606)	(49)	(1,655)
Profit / (loss) before tax	508	(9)	499
Income tax (expense) / credit	(252)	2	(250)
Profit / (loss) for the period	256	(7)	249

Condensed consolidated statement of financial position information	Institutional Securities	Other	Total
As at 30 June 2012	\$millions	\$millions	\$millions
Segment assets	594,234	3,959	598,193
Total assets	594,234	3,959	598,193
Segment liabilities	580,488	3,955	584,443
Total Liabilities	580,488	3,955	584,443

Other segment information

Depreciation on property, plant and equipment	2	-	2
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MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2012

6. SEGMENT REPORTING (CONTINUED)

Business segments (continued)

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

Condensed consolidated statement of financial position information	Institutional Securities	Other	Total
As at 31 December 2011	\$millions	\$millions	\$millions
Segment assets	571,117	4,468	575,585
Total assets	571,117	4,468	575,585
Segment liabilities	557,827	4,280	562,107
Total Liabilities	557,827	4,280	562,107

Other segment information

Property, plant and equipment capital expenditure	3	-	3
Depreciation on property, plant and equipment	4	-	4

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

6. SEGMENT REPORTING (CONTINUED)

Geographical segments

The Group operates in three geographic regions as listed below:

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

The following table presents selected consolidated income statement and consolidated statement of financial position information of the Group’s operations by geographic area. The external revenues (comprising ‘Net gains on financial instruments classified as held for trading’, ‘Net gains on financial instruments designated at fair value through profit or loss’, ‘Interest income’, ‘Interest expense’ and ‘Other income’) and total assets disclosed in the following table reflect the regional view of the Group’s operations, on a managed basis. The basis for attributing external revenues (net of interest expense) and total assets is determined by a combination of client and trading desk location.

Geographical Segments	EMEA		Americas		Asia		Total	
	30 June 2012	30 June 2011	30 June 2012	30 June 2011	30 June 2012	30 June 2011	30 June 2012	30 June 2011
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
External revenues	1,929	2,153	42	60	183	7	2,154	2,220
Profit before income tax	330	371	11	46	158	6	499	423
	30 June 2012	31 Dec 2011	30 June 2012	31 Dec 2011	30 June 2012	31 Dec 2011	30 June 2012	31 Dec 2011
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Total assets	509,991	442,096	37,797	93,754	50,405	39,735	598,193	575,585

External revenues and profit before income tax for the Asia geographic segment includes other income of \$148 million representing the expected reimbursement from clients on certain equity positions, as discussed in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT

Risk management procedures

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

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

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

Credit risk

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

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

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

Credit risk management takes place at the transaction, counterparty and portfolio levels. In order to help protect the Group from losses resulting from its business activities, the Group analyses all material lending and derivative transactions and ensures that the creditworthiness of the Group's counterparties and borrowers is reviewed regularly and that credit exposure is actively monitored and managed. The Group assigns obligor credit ratings to its counterparties and borrowers which reflect an assessment of a counterparty's probability of default. For lending transactions, the Group evaluates the relative position of its particular exposure in the borrower's capital structure and relative recovery prospects. Where applicable, the Group also considers collateral arrangements and other structural elements of the particular transaction. The Group has credit guidelines that limit potential credit exposure to any one borrower or counterparty and to aggregates of borrowers or counterparties; these limits are monitored and credit exposures relative to these limits are reported to key management personnel.

As well as assessing and monitoring its credit exposure and risk at the individual counterparty level, the Group also reviews its credit exposure and risk to geographic regions. As at 30 June 2012, credit exposure was concentrated in North America and Western European countries. In addition, the Group pays particular attention to smaller exposures in emerging markets given their higher risk profile. Country ceiling ratings are derived using methodologies generally consistent with those employed by external rating agencies.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

The Group also reviews its credit exposure and risk to types of customers. At 30 June 2012, the Group's material credit exposure was to corporate entities, sovereign-related entities and financial institutions.

Collateral and other credit enhancements

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

Reverse repurchase agreements and securities borrowed

The Group manages credit exposure arising from reverse repurchase agreements and securities borrowed transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Group, in the event of a counterparty default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. Under these reverse repurchase agreements and securities borrowed transactions, the Group receives collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt and corporate equities. The Group also monitors the fair value of the underlying securities compared to the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralised.

Derivatives

The Group may seek to mitigate credit risk from its derivatives transactions in multiple ways. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size and maturity. The Group actively hedges its derivatives exposure through various financial instruments that may include single name, portfolio and structured credit derivatives. Additionally, the Group may enter into master netting agreements and collateral arrangements with counterparties. These master netting agreements and collateral arrangements may provide the Group with the ability to offset a counterparty's rights and obligations, to request additional collateral when necessary and / or to liquidate the collateral in the event of counterparty default. The Group monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral in accordance with collateral arrangements when deemed necessary.

Exposure to credit risk

The maximum exposure to credit risk ("gross credit exposure") of the Group as at 30 June 2012 is disclosed below, based on the carrying amounts of the financial assets the Group believes are subject to credit risk. Exposure arising from financial instruments not recognised on the consolidated statement of financial position is measured as the maximum amount that the Group could have to pay, which may be significantly greater than the amount that would be recognised as a liability. This table does not include receivables arising from pending securities transactions with market counterparties. The "unrated" balance represents the pool of counterparties that either do not require a rating or are under review in accordance with the Morgan Stanley Group's rating policies. These counterparties individually generate no material credit exposure and this pool is highly diversified, monitored and subject to limits.

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class

Class	Gross credit exposure	Gross credit exposure
	30 June 2012 \$millions	31 December 2011 \$millions
Loans and receivables:		
Cash at bank	11,772	11,180
Securities borrowed	31,852	29,575
Reverse repurchase agreements	109,497	97,218
Trade receivables	53,533	44,113
Other receivables	5,865	7,096
Financial assets classified as held for trading:		
OTC Derivatives	276,295	291,005
Financial assets designated at fair value through profit or loss	7,137	8,562
	<u>495,951</u>	<u>488,749</u>
Unrecognised financial instruments		
Contingent commitments	2,332	3,010
Financial guarantees	1	1
Underwriting commitments	159	156
Loan commitments	880	986
Unsettled reverse repurchase agreements	39,317	22,448
	<u>538,640</u>	<u>515,350</u>

Maximum exposure to credit risk by credit rating (1)

Credit rating	Gross credit exposure	Gross credit exposure
	30 June 2012 \$millions	31 December 2011 \$millions
AAA	24,746	22,157
AA	135,555	79,850
A	297,831	338,888
BBB	47,812	49,771
BB	10,320	7,086
B	8,307	9,924
CCC	5,473	3,592
Unrated	8,596	4,082
Total	<u>538,640</u>	<u>515,350</u>

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

At 30 June 2012 there were no financial assets past due but not impaired (30 June 2011: None). At 30 June 2012 there were no financial assets individually impaired (30 June 2011: None).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk

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

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

Liquidity management policies

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

Contingency Funding Plan. The CFP describes the data and information flows, limits and triggers, escalation procedures, roles and responsibilities and available mitigating actions in the event of a liquidity stress. The CFP assesses current and future funding sources and uses and establishes a plan for monitoring and managing a potential liquidity stress event. A set of escalation triggers identifies early signs of stress and activates a response plan.

Liquidity Stress Tests. Liquidity Stress Tests model illiquidity outflows across multiple scenarios over a range of time horizons.

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

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

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

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

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

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

Funding management policies

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

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

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

Maturity analysis

In the following maturity analysis of financial liabilities, derivative contracts and other financial liabilities held as part of the Group’s trading activities are disclosed as on demand and presented at fair value, consistent with how these financial liabilities are managed. Derivatives not held as part of the Group’s trading activities and financial liabilities designated at fair value through profit and loss are disclosed according to their earliest contractual maturity; all such amounts are presented at their fair value, consistent with how these financial liabilities are managed. All other amounts represent undiscounted cash flows payable by the Group arising from its financial liabilities to earliest contractual maturities as at 30 June 2012. Repayments of financial liabilities that are subject to immediate notice are treated as if notice were given immediately and are classified as on demand. This presentation is considered by the Group to appropriately reflect the liquidity risk arising from those financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial liabilities is managed by the Group.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Maturity analysis (continued)

	On demand	Less than 1 month	More than 1 month but less than 3 months	More than 3 months but less than 1 year	More than 1 year but less than 5 years	More than 5 years	Total
30 June 2012	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	213	-	-	-	-	-	213
Securities loaned	23,612	317	2,436	2,567	700	-	29,632
Repurchase agreements	29,469	20,843	15,568	11,511	1,719	36	79,146
Trade payables	106,894	-	-	-	-	-	106,894
Other payables	8,738	4	9	10,680	212	3,639	23,282
Subordinated loans	-	11	23	101	541	9,035	9,711
Financial liabilities classified as held for trading:							
Derivatives	290,999	-	-	-	-	-	290,999
Other	35,523	-	-	-	-	-	35,523
Financial liabilities designated at fair value through profit or loss							
	6,979	28	182	660	2,786	661	11,296
Total financial liabilities	502,427	21,203	18,218	25,519	5,958	13,371	586,696
Unrecognised financial instruments							
Contingent commitments	2,332	-	-	-	-	-	2,332
Financial guarantees	1	-	-	-	-	-	1
Lease commitments	8	-	-	-	21	17	46
Underwriting commitments	100	-	-	59	-	-	159
Loan commitments	880	-	-	-	-	-	880
Unsettled reverse repurchase agreements	39,317	-	-	-	-	-	39,317
Total unrecognised financial instruments	42,638	-	-	59	21	17	42,735

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

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Maturity analysis (continued)

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

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

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk

Market risk refers to the exposure of the Group to adverse changes in the values of its portfolios and financial instruments due to changes in market prices or rates. Generally, the Group is exposed to market risk as a result of trading, investing and client facilitation activities, mainly within the Institutional Securities business segment where the substantial majority of the Company's Value-at-Risk ("VaR") for market risk exposures is generated.

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

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

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

Risk and capital management initiative

The Group also performs routine stress testing to more comprehensively monitor the risks in the portfolio. The group utilises Stress VaR ("S-VaR"), which is a proprietary methodology that seeks to measure both the Group's market and credit risks, while adjusting for the different liquidity characteristics of the underlying risks (in contrast to traditional VaR measures which are typically calculated using the same liquidity horizon for all risks).

Primary market risk exposures and market risk management

During the six month period ended 30 June 2012, the Group had exposures to a wide range of interest rates, equity prices, foreign exchange rates and commodity prices and the associated implied volatilities and spreads related to the global markets in which it conducts its trading activities.

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

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

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

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Primary market risk exposures and market risk management (continued)

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

The Group, as part of the Morgan Stanley Group's global market risk management framework manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (e.g., futures, forwards, swaps and options). Hedging activities may not always provide effective mitigation against trading losses due to differences in the terms, specific characteristics or other basis risks that may exist between the hedge instrument and the risk exposure that are being hedged. The Group manages the market risk associated with its trading activities on a Group basis, on an entity-wide basis, on a worldwide trading division level and on an individual product strategy level. The Group manages and monitors its market risk exposures in such a way as to maintain a portfolio that the Group believes is well-diversified in the aggregate with respect to market risk factors and that reflects the aggregate risk tolerance of key entities within the Group as established by the Group's senior management.

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

VaR

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

VaR methodology, assumptions and limitations

The Group estimates VaR using a model based on historical simulation for major market risk factors and Monte Carlo simulation for name-specific risk in corporate shares, bonds, loans and related derivatives. Historical simulation involves constructing a distribution of hypothetical daily changes in the value of trading portfolios based on two sets of inputs: historical observation of daily changes in key market indices or other market risk factors; and information on the current sensitivity of the portfolio values to these market risk factor changes. The Group's VaR model uses four years of historical data to characterise potential changes in market risk factors. The Group's 95%/one-day VaR corresponds to the unrealised loss in portfolio value that, based on historically observed market risk factor movements, would have been exceeded with a frequency of 5%, or five times in every 100 trading days, if the portfolio were held constant for one day.

The Group's VaR model generally takes into account linear and non-linear exposures to equity and commodity price risk, interest rate risk, credit spread risk and foreign exchange rates. The model also takes into account linear exposures to implied volatility risks for all asset classes and non-linear exposures to implied volatility risks for equity, commodity and foreign exchange referenced products. The VaR model also captures certain implied correlation risks associated with portfolio credit derivatives as well as certain basis risks (e.g., corporate debt and related credit derivatives).

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR methodology, assumptions and limitations (continued)

Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of varied market risks and portfolio assets. One key element of the VaR model is that it reflects risk reduction due to portfolio diversification or hedging activities. However, VaR risk measures should be interpreted carefully in light of the methodology's limitations, which include but are not limited to: past changes in market risk factors may not always yield accurate predictions of the distributions and correlations of future market movements; changes in portfolio value in response to market movements (especially for complex derivative portfolios) may differ from the responses calculated by a VaR model; VaR using a one-day time horizon does not fully capture the market risk of positions that cannot be liquidated or hedged within one day; the historical market risk factor data used for VaR estimation may provide only limited insight into losses that could be incurred under market conditions that are unusual relative to the historical period used in estimating the VaR; and published VaR results reflect past trading positions while future risk depends on future positions. A small proportion of market risk generated by trading positions is not included in VaR. The modelling of the risk characteristics of some positions relies on approximations that, under certain circumstances, could produce significantly different results from those produced using more precise measures.

VaR is most appropriate as a risk measure for trading positions in liquid financial markets and will understate the risk associated with severe events, such as periods of extreme illiquidity. The Group is aware of these and other limitations and, therefore, uses VaR as only one component in its risk management oversight process. As explained above, this process also incorporates stress testing and scenario analyses and extensive risk monitoring, analysis, and control at the trading desk, division and Group levels.

The Group's VaR models evolve over time in response to changes in the composition of trading portfolios and to improvements in modelling techniques and systems capabilities. The Group is committed to continuous review and enhancement of VaR methodologies and assumptions in order to capture evolving risks associated with changes in market structure and dynamics. As part of regular process improvement, additional systematic and name-specific risk factors may be added to improve the VaR model's ability to more accurately estimate risks to specific asset classes or industry sectors. Additionally, the Group continues to evaluate enhancements to the VaR model to make it more responsive to more recent market conditions while maintaining a longer-term perspective.

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR methodology, assumptions and limitations (continued)

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

Sensitivity analysis

VaR for the six month period ended 30 June 2012

The table below presents VaR for the Group's Trading portfolio, on a period-end, period average and period high and low basis for 30 June 2012 and 31 December 2011.

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

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

Market Risk Category	95% / one-day VaR for the six months ended 30 June 2012				95% / one-day VaR for the year ended 31 December 2011			
	Period		High \$'m	Low \$'m	Period		High \$'m	Low \$'m
	End \$'m	Average \$'m			End \$'m	Average \$'m		
Interest rate and credit spread	20	26	37	20	27	36	52	24
Equity price	22	22	35	15	16	21	33	13
Foreign exchange rate	5	5	10	3	6	6	15	2
Commodity price	2	2	4	1	3	5	12	2
Less: Diversification benefit ⁽¹⁾⁽²⁾	(22)	(22)	N/A	N/A	(25)	(25)	N/A	N/A
Primary Risk Categories VaR	27	33	50	25	27	43	67	27
Credit Portfolio VaR	15	17	21	11	18	21	26	16
Less: Diversification benefit ⁽¹⁾⁽²⁾	(13)	(10)	N/A	N/A	(10)	(10)	N/A	N/A
Total trading VaR	29	40	59	29	35	54	78	35

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR for the six month period ended 30 June 2012 (continued)

The Group's average VaR for the Primary Risk Categories for the six month period to 30 June 2012 was \$33 million compared with \$43 million for the year to 31 December 2011. Reduced risk taking in fixed income products was the primary driver of the decrease.

The average Credit Portfolio VaR for the six month period to 30 June 2012 was \$17 million compared with \$21 million for the year to 31 December 2011. The decrease in the average VaR over period was from reduced counterparty exposure, resulting in a lower Credit Portfolio VaR for the six month period to 30 June 2012.

The average Total Trading VaR for the six month period to 30 June 2012 was \$40 million compared with \$54 million for the year ended 31 December 2011.

Non-trading risks for the six month period ended 30 June 2012

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

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net gain or loss of approximately \$6.3 million as at 30 June 2012, compared to a net gain or loss of \$3.8 million as at 31 December 2011.

Counterparty exposure related to the Group's own spreads

The credit spread risk relating to the Group's own mark-to-market derivative counterparty exposure corresponds to an increase in value of approximately \$2 million for each 1 basis point widening in the Group's credit spread level at both 30 June 2012 and 31 December 2011.

Structured notes

The credit spread risk sensitivity of the Group's mark-to-market structured notes corresponded to a decrease in value of approximately \$0.4 million for each 1 basis point widening in the Group's credit spread level at both 30 June 2012 and 31 December 2011.

Equity price risk

The Group is exposed to equity price risk as a result of changes in the fair value of its investments in both public and private companies that are measured and reported as "Available-for-sale financial assets" in the condensed consolidated statement of financial position. These investments are predominantly equity positions with long investment horizons, the majority of which are for business facilitation purposes. The market risk related to these investments is measured by estimating the potential reduction in net revenues associated with a 10% decline in investment values.

	30 June 2012	31 December 2011
	10% sensitivity	10% sensitivity
	\$millions	\$millions
Available-for-sale financial assets	10	7
	<u>10</u>	<u>7</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

7. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk

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

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

Foreign currency exposure	30 June 2012			31 December 2011		
	Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)		
	\$millions	Percentage change applied %	Other comprehensive income \$millions	\$millions	Percentage change applied %	Other comprehensive income \$millions
Australian Dollar	(24)	27%	6	(6)	27%	2
Euro	418	9%	38	405	7%	28
British Pound	52	29%	15	51	29%	15
New Taiwan Dollar	69	8%	6	66	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Singapore Dollar	-	9%	-	-	9%	-
South Korean Won	180	42%	76	168	42%	71
Swedish Krona	15	23%	3	15	23%	3
Swiss Franc	7	10%	1	7	10%	1
	<u>719</u>			<u>708</u>		

The reasonably possible percentage change in the currency rate against US dollars has been calculated based on the greatest annual percentage change over a five-year period from 1 December 2007 to 30 June 2012. Thus the percentage change applied may not be the same percentage change in the currency rate for the six month period to 30 June 2012.

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

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8. SPECIAL PURPOSE ENTITIES

The Group is involved with various entities in the normal course of business that may be deemed to be special purpose entities (“SPEs”). The Group’s interests in SPEs include debt and equity interests and derivative instruments, and these interests primarily arise from trading activity and structured transactions. Consolidation of SPEs is determined in accordance with the Group’s accounting policies. As at 30 June 2012 the total assets of SPEs in which the Group has an interest, but which are not consolidated by the Group, are \$90 million (31 December 2011: \$212 million) and the Group’s maximum exposure to loss relating to such SPEs is \$31 million (31 December 2011: \$174 million). The Group’s condensed consolidated statement of financial position includes \$2,356 million of assets arising from consolidated SPEs (31 December 2011: \$2,904 million). The Group’s maximum exposure to loss relating to these assets is \$1,505 million (31 December 2011: \$1,279 million).

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Fair value hierarchy disclosure

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

- *Quoted prices (unadjusted) in an active market for identical assets or liabilities (Level 1)* - valuations based on quoted prices in active markets for identical assets or liabilities that the Morgan Stanley Group has the ability to access. Valuation adjustments and block discounts are not applied to Level 1 instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuations of these products do not entail a significant degree of judgement.
- *Valuation techniques using observable inputs (Level 2)* - valuations based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- *Valuation techniques with significant non-observable inputs (Level 3)* - valuations based on inputs that are unobservable and significant to the overall fair value measurement.

Fair Value Control Processes

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

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

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

Financial assets and liabilities recognised at fair value

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

30 June 2012

	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant non- observable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
- Government debt securities	10,356	2,702	-	13,058
- Corporate equities	8,106	9,302	700	18,108
- Corporate and other debt	1	8,103	1,614	9,718
- Derivatives	968	290,014	3,221	294,203
Total financial assets classified as held for trading	19,431	310,121	5,535	335,087
Financial assets designated at fair value through profit or loss				
	-	6,523	614	7,137
Available-for-sale financial assets:				
- Corporate equities	2	-	95	97
Total financial assets measured at fair value	19,433	316,644	6,244	342,321
Financial liabilities classified as held for trading:				
- Government debt securities	13,777	911	-	14,688
- Corporate equities	18,139	225	46	18,410
- Corporate and other debt	3	2,370	52	2,425
- Derivatives	955	285,592	4,452	290,999
Total financial liabilities classified as held for trading	32,874	289,098	4,550	326,522
Financial liabilities designated at fair value through profit or loss				
	-	10,950	346	11,296
Total financial liabilities measured at fair value	32,874	300,048	4,896	337,818

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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

Financial assets and liabilities recognised at fair value (continued)

31 December 2011

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

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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

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

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

Government debt securities

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

Corporate equities

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

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

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

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

Corporate and other debt

Residential Mortgage-Backed Securities ("RMBS"), Commercial Mortgage-Backed Securities ("CMBS"), and other Asset-Backed Securities ("ABS"). RMBS, CMBS and other ABS may be valued based on external price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analysing expected credit losses, default and recover rates. In evaluating the fair value of each security, the Group considers security collateral-specific attributes, including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity. In addition, for RMBS borrowers, Fair Issac Corporation ("FICO") scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

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Six months ended 30 June 2012

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

Corporate and other debt (continued)

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

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

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

Derivatives

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

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

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

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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

OTC Derivative Contracts (continued)

Other derivative products, including complex products that have become illiquid, require more judgement in the implementation of the valuation technique applied due to the complexity of the valuation assumptions and the reduced observability of inputs. This includes certain types of interest rate derivatives with both volatility and correlation exposure and credit derivatives including mortgage-related CDO securities, certain types of ABS credit default swaps, basket credit default swaps and CDO-squared positions where direct trading activity or quotes are unobservable. These instruments involve significant unobservable inputs and are categorised in Level 3 of the fair value hierarchy.

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

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

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

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

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

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

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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

Corporate loans

Corporate loans and lending commitments. The fair value of corporate loans is estimated 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 or brokers adjusted for any basis difference between cash and derivative instruments, along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable. The fair value of contingent corporate lending commitments is determined by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of loans and lending commitments also takes into account fee income that is considered an attribute of the contract.

Corporate loans and lending commitments are generally categorised in Level 2 of the fair value hierarchy except in instances where prices or significant spread inputs are unobservable, in which case they are categorised in Level 3 of the fair value hierarchy.

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

The following table presents the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the six months ended 30 June 2012. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realised and unrealised gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realised and unrealised gains (losses) on hedging instruments that have been classified by the Group within the Level 1 and / or Level 2 categories.

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

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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

30 June 2012

	Balance at 1 January 2012	Total gains or losses recognised in profit or loss	Total gains or losses recognised in other comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 ⁽¹⁾	Balance at 30 June 2012	Unrealised gains or (losses) for level 3 assets/liabilities outstanding as at 30 June 2012 ⁽²⁾
	\$'m	\$'m	\$'m	\$'m	\$'m	\$'m	\$'m	\$'m	\$'m	\$'m
Financial assets classified as held for trading:										
- Government debt securities	1	-	-	-	-	-	-	(1)	-	-
- Corporate equities	162	(3)	-	546	(45)	-	-	40	700	(23)
- Corporate and other debt	2,235	(92)	-	236	(320)	-	(455)	10	1,614	(109)
Total financial assets classified as held for trading	2,398	(95)	-	782	(365)	-	(455)	49	2,314	(132)
Financial assets designated at fair value through profit or loss										
	-	-	-	556	-	-	-	58	614	-
Available-for-sale financial assets:										
- Corporate equities	65	-	28	2	-	-	-	-	95	-
Total financial assets measured at fair value	2,463	(95)	28	1,340	(365)	-	(455)	107	3,023	(132)
Financial liabilities classified as held for trading:										
- Corporate equities	(1)	(22)	-	16	(6)	-	-	(33)	(46)	(53)
- Corporate and other debt	(70)	(3)	-	54	(51)	-	-	18	(52)	1
- Net derivative contracts ⁽³⁾	(1,632)	(310)	-	200	-	(79)	776	(186)	(1,231)	(197)
Total financial liabilities classified as held for trading	(1,703)	(335)	-	270	(57)	(79)	776	(201)	(1,329)	(249)
Financial liabilities designated at fair value through profit or loss										
	(381)	42	-	(24)	-	-	17	-	(346)	42
Total financial liabilities measured at fair value	(2,084)	(293)	-	246	(57)	(79)	793	(201)	(1,675)	(207)

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

(2) Amounts represent unrealised gains or (losses) for the period related to assets and liabilities still outstanding as at the end of the period. The unrealised gains or (losses) are recognised in the condensed consolidated income statement or condensed consolidated statement of total recognised gains and losses.

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

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

31 December 2011

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

- (1) For financial assets and financial liabilities that were transferred into and out of Level 3 during the period, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the period.
- (2) Amounts represent unrealised gains or (losses) for the period related to assets and liabilities still outstanding as at the end of the period. The unrealised gains or (losses) are recognised in the condensed consolidated income statement or condensed consolidated statement of total recognised gains and losses.
- (3) Net derivative contracts represent Financial assets classified as held for trading – derivative contracts net of Financial liabilities classified as held for trading – derivative contracts.

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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

As disclosed in note 10 the Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. Where the trading positions included in the above gains or losses are risk managed using financial instruments across a number of Morgan Stanley Group entities, these policies potentially result in the recognition of offsetting gains or losses in the Group.

During the period, there were no significant transfers in relation to Level 3 of the fair value hierarchy.

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

During the six month period to 30 June 2012, the Group reclassified approximately \$1,667 million of derivative assets and approximately \$1,340 million of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange. Also during the period, the Group reclassified approximately \$336 million of derivative assets from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

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

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

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

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

The following table presents the sensitivity of the fair value of Level 3 financial assets and financial liabilities as at 30 June 2012 to reasonably possible alternative assumptions:

30 June 2012	Effect of reasonably possible alternative assumptions		
	Fair value \$millions	Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	700	6	(5)
- Corporate and other debt	1,614	27	(14)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	3	-	-
- Structured notes	-	-	-
- other	611	4	-
Available-for-sale financial assets:			
- Corporate equities	95	13	-
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	46	-	-
- Corporate and other debt	52	-	-
- Net derivatives contracts(1)	1,231	152	(76)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	142	1	-
- Structured notes	2	-	-
- other	202	4	(4)

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

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9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

The following table presents the sensitivity of the fair value of Level 3 financial assets and financial liabilities as at 31 December 2011 to reasonably possible alternative assumptions:

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

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

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2012

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

e. Financial instruments valued using unobservable market data

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

	30 June 2012 \$millions	31 December 2011 \$millions
At 1 January	536	260
New transactions	112	307
Amounts recognised in the consolidated income statement during the period	(38)	(31)
At 30 June / 31 December	610	536

The balance above predominantly relates to derivatives.

The condensed consolidated statement of financial position categories 'Financial assets and financial liabilities classified as held for trading', 'Financial assets and financial liabilities designated at fair value', and 'Investments: Available-for-sale financial assets' may include financial instruments whose fair value is based on valuation techniques using unobservable market data. However, the balance above for the Group predominantly relates to derivatives classified as held for trading.

10. RELATED PARTY DISCLOSURES

The management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. For the six month period ended 30 June 2012, \$346 million was transferred to other Morgan Stanley Group undertakings relating to such policies and recognised in the condensed consolidated income statement (six month period to 30 June 2011: \$691 million was transferred to other Morgan Stanley Group undertakings).

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11. LITIGATION

In the normal course of business, the Group has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and / or punitive damages or claims for indeterminate amounts of damages. While the Group has identified below, where applicable, any new actions or developments which have occurred with respect to certain litigation matters previously reported in the Group annual financial statements for the year ended 31 December 2011, there can be no assurance that material losses will not be incurred from claims that may not yet been notified to the Group or are not yet determined to be probable or possible and reasonably estimable.

On 4 May 2012, the court in *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., et al.* granted the Morgan Stanley Group and the Group's motion to dismiss claims against the Morgan Stanley Group and the Group for breach of fiduciary duty and negligence, and denied the Morgan Stanley Group and the Group's motion to dismiss claims against the Morgan Stanley Group and the Group for negligent misrepresentation. On 2 July 2012, plaintiffs filed supplemental disclosures with the Court alleging that they are seeking approximately \$811 million in compensatory damages. Plaintiffs are also seeking punitive damages.

On 4 May 2012, the court in *King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al.*, granted the Morgan Stanley Group and the Group's motion to dismiss claims against the Morgan Stanley Group and the Group for breach of fiduciary duty and negligence, and denied the Morgan Stanley Group and the Group's motion to dismiss claims against the Morgan Stanley Group and the Group for negligent misrepresentation.