Registered Number: 2068222
Registered Office:
25 Cabot Square
Canary Wharf
London E14 4QA

MORGAN STANLEY & CO. INTERNATIONAL plc

Report and financial statements

31 December 2011

DIRECTORS' REPORT

The Directors present their report and the consolidated financial statements of Morgan Stanley & Co. International plc (the "Company") and all of its subsidiary and associated undertakings (together the "Group"), together with the Company's balance sheet and related notes for the year ended 31 December 2011. The Group's consolidated financial statements have been prepared in accordance with applicable United Kingdom ("UK") law and International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU"). The Company's balance sheet and related notes have been prepared in accordance with applicable UK law and accounting standards.

RESULTS AND DIVIDENDS

The Group's profit for the year, after tax, was $573 million (2010: $247 million after tax).

A dividend of $110 million (2010: $nil) was paid on the Class D preference shares and a dividend of $18 million (2010: $21 million) was paid on the Class B preference shares during the year. No final dividends are proposed.

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 year 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, Greece, Korea, the Netherlands, New Zealand, Poland, the Qatar Financial Centre and Switzerland. The Greek branch has been closed post year end.

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 2011, global market and economic conditions were negatively impacted by concerns about the sovereign debt crisis in Europe, the U.S federal debt ceiling and slower economic growth leading to volatility on the global equity markets.

In Europe, real gross domestic product growth remained moderate in 2011. Major European equity market indices ended 2011 lower compared with the beginning of the year, primarily due to adverse economic developments, including investors' growing 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. The euro area unemployment rate increased to 10.4% at 31 December 2011 from 10.0% a year ago. At 31 December 2011, the European Central Bank's ("ECB") benchmark interest rate was 1.00%, and the Bank of England's ("BOE") benchmark interest rate was 0.50%, both of which were unchanged from a year ago. In 2011, the BOE increased the size of its quantitative easing program by £75 billion to £275 billion in order to inject further monetary stimulus into the economy in UK. To stabilise the European banking system during the sovereign debt crisis, the ECB initiated a number of actions during the fourth quarter of 2011. The ECB made longer-term loans available to banks in exchange for posting of adequate collateral in October and December of 2011 for maturities up to 13 months, ensuring that European banks have unlimited financing into 2013. Starting in November 2011, the ECB also bought €40 billion in European bank bonds backed by mortgages and other assets, known as covered bonds, a key source of funds for banks. On 27 October 2011, leaders of 17 European Union countries announced a financial relief plan that involves a write-off of certain sovereign debt by European banks and other measures aimed to resolve the European sovereign debt crisis. In December 2011, European leaders agreed to sign an inter-government treaty that would require them to enforce stricter fiscal and financial discipline in their future budgets. In January and February 2012, rating agencies downgraded the credit ratings for several euro-zone countries.

The consolidated income statement for the year is set out on page 14. The Group's profit before tax for the year has increased by $62 million to $825 million, compared to the year ended 31 December 2010.

The Group's revenues are best reviewed across the aggregate of 'Net gains on financial instruments classified as held for trading', 'Net gains on financial instruments designated at fair value through profit or loss', 'Net gains on available-for-sale financial assets', 'Interest income', 'Interest expense' and 'Other income'. Despite the challenging market conditions noted above, aggregate revenues have remained stable at $4,118 million in 2011 compared to $4,116 million in 2010. Revenues within equity sales and trading improved year on year mostly offset by lower fixed income sales and trading revenues. The results in 2011 include approximately $600 million primarily related to the release of credit valuation adjustments upon the restructuring of certain derivative transactions which decreased the Group's exposure to certain European countries. Revenue for the year excludes gains of $276 million, compared to $45 million in 2010, not recognised upon initial recognition of financial instruments measured at fair value where valuation techniques include unobservable market data.

The Group's Other expenses have decreased from $3,353 million in 2010, to $3,293 million in 2011 driven by the bank payroll tax in 2010 of $239 million, which no longer applied in 2011, partially offset by the U.K. bank levy charge of $43 million in 2011. The tax charge decreased from $516 million in 2010 to $252 million in 2011 driven by the release of certain tax reserves.

The consolidated statement of financial position presented on page 18 shows increases in the Group's total assets of $66,650 million and total liabilities of $62,303 million, an increase of 13% and 12% respectively as at 31 December 2011 when compared to 31 December 2010. This increase is mainly driven by the increase in the fair value of derivative instruments held for trading as a result of market volatility. Excluding derivative assets held for trading, total assets have decreased by $57,149 million, an 18% movement year on year, driven by corporate equities, corporate and other debt and reverse repurchase agreements. Excluding derivative liabilities held for trading, total liabilities have decreased by $56,902 million, also an 18% movement year on year, driven by stock loan and repurchase agreements. During the year the Group has issued $5,386 million of ordinary share capital, repurchased $2,286 million of equity and debt preference shares, and paid dividends totalling $128 million.

The consolidated statement of cash flows presented on page 19 shows the detail behind a net increase in cash of $573 million (2010: decrease of $2,999 million), driven by $2,847 million (2010: $1,290 million) cash generated by financing activities mainly through the issue of capital during the year, partially offset by $2,300 million (2010: $4,347 million) net cash out flows as part of the operating activities of the Group.

The performance of the Group is included in the results of the Morgan Stanley Group which are disclosed in the Morgan Stanley Group's Annual Report on Form 10-K to the United States Securities and Exchange Commission. The Morgan Stanley Group manages its key performance indicators on a global basis in consideration of individual legal entities. For this reason, the Company's Directors believe that providing performance indicators for the Group itself would not enhance an understanding of the development, performance or position of the business of the Group.

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 26 to the consolidated financial statements provides qualitative and quantitative disclosures about the Group's management and exposure to financial risks and note 32 describes the Morgan Stanley Group and the Group's policies for managing capital.

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.

Risk management (continued)

Credit risk (continued)

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. 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 manages 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 are monitored and managed, with stress testing and scenario analysis conducted on a continuous basis, to identify exposure concentrations, wrong way risk and the impact of idiosyncratic events. In addition, indirect exposures are captured and monitored through regular stress testing and counterparty, market and systemic vulnerability analysis. 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 economically hedging the exposure through the use of, for example, Credit Default Swaps ("CDS").

The Group's country risk exposure including the effect of these risk mitigants is shown below. 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). 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 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 2011, the European Peripherals and France, experienced varying degrees of credit deterioration due to weaknesses in their economic and fiscal situations. Such country risk exposure is measured in accordance with the Group's internal risk management standards and includes obligations from sovereign and non-sovereigns, which includes governments, corporations, clearing houses and financial institutions.

On 22 December 2011 the Group executed certain derivative restructuring amendments which settled on 3 January 2012. Upon settlement of the amendments, the exposure before hedges and net exposure for Italy decreased from $5,017 million and $4,173 million to $1,738 million and $892 million respectively, and the exposure before hedges and net exposure for European Peripherals, including Italy, decreased from $5,893 million and $4,806 million to $2,614 million and $1,525 million, respectively.

The following table shows the Group's country risk exposure to European Peripherals and France at 31 December 2011. The majority of the financial instruments included in the table below are classified as held for trading and 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.

Risk management (continued)

Credit risk (continued)

Country	Net Inventory (1)	Net Counterparty Exposure (2)	Unfunded Commitments	CDS Adjustments (3)	Exposure Before Hedges	Hedges (4)	Net Exposure
	$millions	$millions	$millions	$millions	$millions	$millions	$millions
Greece:							
Sovereigns	25	-	-	10	35	-	35
Non-sovereigns	(5)	1	-	-	(4)	(34)	(38)
Total Greece	20	1	-	10	31	(34)	(3)
Ireland:							
Sovereigns	85	1	-	4	90	-	90
Non-sovereigns	70	19	-	1	90	-	90
Total Ireland	155	20	-	5	180	-	180
Italy (5):							
Sovereigns	80	4,164	-	159	4,403	(583)	3,820
Non-sovereigns	(57)	445	142	84	614	(261)	353
Total Italy (5)	23	4,609	142	243	5,017	(844)	4,173
Spain:							
Sovereigns	(266)	(1)	-	496	229	123	352
Non-sovereigns	84	370	96	139	689	(161)	528
Total Spain	(182)	369	96	635	918	(38)	880
Portugal:							
Sovereigns	(409)	76	-	23	(310)	(109)	(419)
Non-sovereigns	(75)	112	-	20	57	(62)	(5)
Total Portugal	(484)	188	-	43	(253)	(171)	(424)
Sovereigns	(485)	4,240	-	692	4,447	(569)	3,878
Non-sovereigns:	17	947	238	244	1,446	(518)	928
Total European Peripherals	(468)	5,187	238	936	5,893	(1,087)	4,806
France:							
Sovereigns	(1,760)	225	-	-	(1,535)	(47)	(1,582)
Non-sovereigns	(426)	1,524	577	10	1,685	(655)	1,030
Total France	(2,186)	1,749	577	10	150	(702)	(552)

(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 funded lending. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(5) On 22 December 2011 the Group executed certain derivative restructuring amendments which settled on 3 January 2012. Upon settlement of the amendments, the exposure before hedges and net exposure for Italy decreased to $1,738 million and $892 million respectively, and the exposure before hedges and net exposure for European Peripherals decreased to $2,614 million and $1,525 million, respectively.

Risk management (continued)

Credit risk (continued)

The following table shows the Group's significant non-U.K country risk exposure at 31 December 2011, excluding select European countries disclosed above. Exposure to other Morgan Stanley Group undertakings has been excluded from the table below.

Country	Net Inventory [(1)]	Net Counterparty Exposure [(2)]	Exposure Before Hedges	Hedges [(3)]	Net Exposure
	$millions	$millions	$millions	$millions	$millions
Australia:					
Sovereigns	(171)	-	(171)	-	(171)
Non-sovereigns	551	318	869	-	869
Total Australia	380	318	698	-	698
Netherlands:					
Sovereigns	(133)	6	(127)	(229)	(356)
Non-sovereigns	74	901	975	-	975
Total Netherlands	(59)	907	848	(229)	619
China:					
Sovereigns	94	172	266	-	266
Non-sovereigns	195	165	360	(47)	313
Total China	289	337	626	(47)	579
Denmark:					
Sovereigns	209	-	209	-	209
Non-sovereigns	70	73	143	-	143
Total Denmark	279	73	352	-	352
Kazakhstan:					
Sovereigns	-	3	3	-	3
Non-sovereigns	290	50	340	-	340
Total Kazakhstan	290	53	343	-	343

(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 funded lending. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

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 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. Throughout 2011, the Morgan Stanley Group has been focused on the composition of its funding liabilities, reducing reliance on short term funding in favour of more diverse and durable funding sources. This remains an ongoing objective of the Morgan Stanley Group.

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

During the latest Comprehensive Capital Analysis and Review performed by the Federal Reserve, Morgan Stanley Group exceeded the minimum capital ratio even under the most negative "stressed" scenario, which reaffirms the improvements done in recent years to reduce risk and overhauling the quality and quantity of the capital base.

The Group has continued to actively manage its capital position. During the year the Company undertook a restructuring of its capital issuing $5,386 million of ordinary share capital, repurchasing $2,286 million of equity and debt preference shares, and paying dividends totalling $128 million. During the year the Group complied with all regulatory capital requirements, ensuring sufficient Capital Resources were held.

Note 32 to the consolidated financial statements, provides additional information regarding the Group's capital position.

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as liquidity, will result in losses for a position or portfolio.

During the current year the Group has seen the average VaR for the Primary Risk Categories decline from $60 million in 2010, to $43 million in 2011. This has been driven by reduced risk taking in fixed income products that occurred during the second half of the year, and this is also the reason behind the reduction in the year-end VaR to $27 million from $56 million in 2010. The credit portfolio VaR has increased on an average basis from $17 million in 2010 to $21 million in 2011, primarily due to higher counterparty exposure during 2011, although this had decreased at year-end.

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.

Risk management (continued)

Operational risk (continued)

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

The Group's operations rely on the secure processing, storage and transmission of confidential and other information in its computer systems and may be vulnerable to 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 Group's, the Group's clients', the Group's counterparties' or third parties' operations, which could result in reputational damage, litigation or regulatory fines or penalties not covered by insurance maintained by the Group, or adversely affect the business, financial condition or results of operations.

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

The Morgan Stanley Group has established a 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.

Risk management (continued)

Legal and regulatory risk (continued)

Significant changes in the way that major financial services institutions are regulated are occurring in the UK, Europe, the United States ("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 over-the-counter ("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.

Basel II Pillar 3 disclosures

The disclosures for the Group made in order to comply with the FSA's rules, which implement in the UK the EU Directives underlying the revised capital adequacy framework, are incorporated in the Pillar 3 disclosures of Morgan Stanley International Limited ("MSI"), which are available on the Morgan Stanley website.

Continuing market uncertainty

During the year 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 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 we are continually assessing the impact of these changes.

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 both the Morgan Stanley Group and the Group's capital positions. 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 U.S. Federal Reserve.

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 annual report and financial statements.

DIRECTORS

The following Directors held office throughout the year and to the date of approval of this report (except where otherwise shown):

P Bailas	(appointed 10 May 2011)
C D S Bryce	
M C Bowe	(resigned 27 July 2011)
W A Chammah	(resigned 3 March 2011)
L G P M Francois	(resigned 16 March 2012)
T C Kelleher (Chairman)	(appointed 6 May 2011)
G G Lynch	(resigned 21 March 2011)
F R Petitgas	
I Plenderleith	(appointed 1 December 2011)
R Rooney	
D A Russell	(appointed 16 June 2011)
C E Woodman	

DIRECTORS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance is taken out by Morgan Stanley, the Company's ultimate parent undertaking, for the benefit of the Directors and Officers of the Company.

QUALIFYING THIRD PARTY INDEMNITY PROVISIONS

Qualifying third party indemnity provisions (as defined in section 234 of the Companies Act 2006) were in force during the year and up to and including the date of the Directors' report for the benefit of all the Directors of the Company.

AUDIT COMMITTEE

Morgan Stanley International Limited ("MSI"), the Company's ultimate UK parent undertaking, has an Audit Committee which assists the Boards of MSI, the Company, other MSI regulated subsidiary undertakings and certain other Morgan Stanley Group undertakings in meeting their responsibilities in ensuring an effective system of internal control and compliance, and in meeting their external financial reporting obligations. The Audit Committee meets regularly and reports to the MSI Board on a quarterly basis.

POST BALANCE SHEET EVENTS

There have been no significant events since the balance sheet date.

POLICY AND PRACTICE ON PAYMENT OF CREDITORS

The Group's and the Company's trade creditor balances are comprised primarily of unsettled securities transactions with exchanges, clearing houses, market counterparties, individual investors and other Morgan Stanley Group undertakings. It is the Company's policy that these transactions are settled in accordance with the standard terms of the relevant exchange or market and disclosure of creditor days is not considered a relevant measure.

EMPLOYEE REMUNERATION

The Group employs staff directly through branches of the Company, in addition to utilising staff employed by other Morgan Stanley Group undertakings. The Group's policies are comparable and consistent with those of Morgan Stanley Group, which include the deferral of significant portions of certain key employees' discretionary compensation. Note 33 to the consolidated financial statements provides additional information and disclosure regarding the Group's compensation policies.

AUDITORS

Deloitte LLP have expressed their willingness to continue in office as auditors of the Company and a resolution to re-appoint them will be proposed at the forthcoming annual general meeting.

Statement as to disclosure of information to auditors

Each of the persons who are Directors of the Company at the date when this report is approved confirms that:

- so far as each of the Directors is aware, there is no relevant audit information (being information needed by the Group's auditors in connection with preparing their report) of which the Group's auditors are unaware; and
- each of the Directors has taken all the steps that he / she ought to have taken as a Director to make himself / herself aware of any relevant audit information and to establish that the Group's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of s418 of the Companies Act 2006.

Approved by the Board and signed on its behalf by C DS BRYCE

Director
23 April 2012

DIRECTORS' RESPONSIBILITY STATEMENT

The Directors are responsible for preparing their annual report and the consolidated financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. The Directors are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and Article 4 of the IAS Regulation and have chosen to prepare the Company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Standards and applicable law). Under company law the Directors must not approve the accounts unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period.

In preparing the Group financial statements, the Directors are required by International Accounting Standard 1 ("IAS 1") to:

(a) properly select and apply accounting policies;

(b) present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;

(c) provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and

(d) make an assessment of the Group's ability to continue as a going concern.

In preparing the Company financial statements the Directors are required to:

(a) select suitable accounting policies and then apply them consistently;

(b) make judgements and estimates that are reasonable and prudent;

(c) state whether applicable UK Accounting Standards have been followed; and

(d) prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors, the names of whom are set out on page 9 of the Directors' report, confirm to the best of their knowledge:

- in accordance with rule 4.1.12(3)(a) of the Financial Services Authority's Disclosure and Transparency Rules, the consolidated financial statements, which have been prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and as endorsed by the EU, have been prepared in accordance with the applicable set of accounting standards and give a true and fair view of the assets, liabilities, financial position and profit or loss of the Group and the undertakings included in the consolidation taken as a whole; and
- the management report represented by the Directors' report has been prepared in accordance with rule 4.1.12(3)(b) of the Disclosure and Transparency Rules, and includes a fair review of the development and performance of the business and the position of the Group and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that the Group faces.

Approved by the Board and signed on its behalf by C BS BRYCE

Director

23 April 2012

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY & CO. INTERNATIONAL plc

We have audited the Group and Company financial statements ("the financial statements") of Morgan Stanley & Co. International plc for the year ended 31 December 2011, which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity, the consolidated statement of financial position and the consolidated statement of cash flows and the Company balance sheet and the related notes 1 to 35 for the consolidated financial statements and the related notes 1 to 20 for the Company financial statements. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union. The financial reporting framework that has been applied in the preparation of the Company financial statements is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's 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 and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditors

As explained more fully in the Directors' responsibility statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the Group's and the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and the Company's affairs as at 31 December 2011 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the Company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the Company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Robert Topley (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London
23 April 2012

CONSOLIDATED INCOME STATEMENT
Year ended 31 December 2011

	Note	2011 $millions	2010 $millions
Net gains on financial instruments classified as held for trading		3,539	3,652
Net gains on financial instruments designated at fair value through profit or loss		275	318
Net gains on available-for-sale financial assets		-	59
Interest income	4	4,003	3,852
Interest expense	4	(3,990)	(3,953)
Other income	5	265	188
Other expense	6	(3,293)	(3,353)
Gain on disposal of subsidiaries	21	5	-
Gain on disposal of joint venture	14	21	-
PROFIT BEFORE TAX		825	763
Income tax expense	7	(252)	(516)
PROFIT FOR THE YEAR		573	247
Attributable to:			
Equity holders of the Company		572	246
Non-controlling interests		1	1
PROFIT FOR THE YEAR		573	247

All operations were continuing in the current and prior year.

The notes on pages 20 to 93 form an integral part of the financial statements.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
Year ended 31 December 2011

	Note	2011 $millions	2010 $millions
PROFIT FOR THE YEAR		573	247
OTHER COMPREHENSIVE INCOME			
Currency translation reserve:			
Foreign currency translation differences on foreign operations		(20)	(30)
Foreign currency reclassification on disposal of subsidiaries		(5)	-
Fair value reserve:			
Net change in fair value of available-for-sale financial assets	12	24	4
Net amount transferred to consolidated income statement		-	(3)
Pension reserve:			
Actuarial gains / (losses) on defined benefit pension plans	34	2	(3)
Income tax relating to components of other comprehensive income	7	(3)	2
OTHER COMPREHENSIVE INCOME AFTER INCOME TAX		(2)	(30)
TOTAL COMPREHENSIVE INCOME		571	217
Attributable to:			
Equity holders of the Company		573	216
Non-controlling interests		(2)	1
TOTAL COMPREHENSIVE INCOME		571	217

The notes on pages 20 to 93 form an integral part of the financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
Year ended 31 December 2011

2011	Share capital	Share premium	Currency translation reserve	Capital redemption reserve	Capital contribution reserve	Fair value reserve	Retained earnings	Equity attributable to equity holders of the Company	Non-controlling interest	Total equity
	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions
Balance at 1 January 2011	5,578	513	(149)	1,399	3	(2)	1,716	9,058	73	9,131
Profit for the year	-	-	-	-	-	-	572	572	1	573
Other comprehensive income:										
Foreign currency translation differences on foreign operations	-	-	(17)	-	-	-	-	(17)	(3)	(20)
Foreign currency reclassification on liquidation of subsidiary	-	-	11	-	-	-	(11)	-	-	-
Foreign currency reclassification on disposal of subsidiaries	-	-	(5)	-	-	-	-	(5)	-	(5)
Net change in fair value of available-for-sale assets recognised directly in equity	-	-	-	-	-	24	-	24	-	24
Actuarial gain on defined benefit pension plans	-	-	-	-	-	-	2	2	-	2
Income tax relating to components of other comprehensive income	-	-	3	-	-	(6)	-	(3)	-	(3)
Total comprehensive income	-	-	(8)	-	-	18	563	573	(2)	571
Transactions with owners:										
Ordinary shares issued	5,386	-	-	-	-	-	-	5,386	-	5,386
Preference shares repurchased	(1,500)	-	-	-	-	-	-	(1,500)	-	(1,500)
Dividends to equity holders of the Company	-	-	-	-	-	-	(110)	(110)	-	(110)
Balance at 31 December 2011	9,464	513	(157)	1,399	3	16	2,169	13,407	71	13,478

The notes on pages 20 to 93 form an integral part of the financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
Year ended 31 December 2011

2010	Share capital	Share premium	Currency translation reserve	Capital redemption reserve	Capital contribution reserve	Fair value reserve	Retained earnings	Equity attributable to equity holders of the Company	Non-controlling interest	Total equity
	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions
Balance at 1 January 2010	3,078	513	(62)	1,399	3	(3)	1,815	6,743	74	6,817
Reclassification from currency translation reserve to retained earnings net of income tax	-	-	(45)	-	-	-	45	-	-	-
Profit for the year	-	-	-	-	-	-	246	246	1	247
Other comprehensive income:										
Foreign currency translation differences on foreign operations	-	-	(30)	-	-	-	-	(30)	-	(30)
Reclassification adjustment on disposal of foreign operation	-	-	(14)	-	-	-	14	-	-	-
Net change in fair value of available-for-sale assets recognised directly in equity	-	-	-	-	-	4	-	4	-	4
Net fair value amount transferred to consolidated income statement	-	-	-	-	-	(3)	-	(3)	-	(3)
Actuarial losses on defined benefit pension plans	-	-	-	-	-	-	(3)	(3)	-	(3)
Income tax relating to components of other comprehensive income	-	-	2	-	-	-	-	2	-	2
Total comprehensive income	-	-	(87)	-	-	1	302	216	1	217
Transactions with owners:										
Preference shares issued	2,500	-	-	-	-	-	-	2,500	-	2,500
Dividends to equity holders of the Company	-	-	-	-	-	-	(401)	(401)	-	(401)
Repayment of capital	-	-	-	-	-	-	-	-	(2)	(2)
Balance at 31 December 2010	5,578	513	(149)	1,399	3	(2)	1,716	9,058	73	9,131

The notes on pages 20 to 93 form an integral part of the financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc
Registered Number: 2068222

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
As at 31 December 2011

	Note	2011 $millions	2010 $millions
ASSETS			
Loans and receivables:			
Cash at bank	8	11,180	10,436
Securities borrowed		29,575	27,852
Reverse repurchase agreements		97,218	112,183
Trade receivables		67,371	64,027
Other receivables	9	7,225	13,567
		212,569	228,065
Financial assets classified as held for trading (of which approximately $33,132 million (2010: $51,974 million) were pledged to various parties)	10	354,143	270,994
Financial assets designated at fair value through profit or loss	11	8,562	9,359
Available-for-sale financial assets	12	67	44
Current tax		145	377
Deferred tax assets	19	44	48
Prepayments and accrued income		45	29
Property, plant and equipment	13	10	12
Joint venture	14	-	7
TOTAL ASSETS		575,585	508,935
LIABILITIES AND EQUITY			
Financial liabilities at amortised cost:			
Bank loans and overdrafts		124	60
Securities loaned		26,016	53,059
Repurchase agreements		76,904	102,528
Trade payables		83,626	75,639
Other payables	15	21,707	24,557
Subordinated loans	16	7,906	7,906
Preference shares	17	-	786
		216,283	264,535
Financial liabilities classified as held for trading	10	333,825	220,793
Financial liabilities designated at fair value through profit or loss	11	11,710	13,713
Provisions	18	10	29
Current tax		68	434
Deferred tax liabilities	19	7	5
Accruals and deferred income		200	291
Retirement benefit obligations	34	4	4
TOTAL LIABILITIES		562,107	499,804
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY			
Share capital	21	9,464	5,578
Share premium account		513	513
Other reserves		1,261	1,251
Retained earnings		2,169	1,716
		13,407	9,058
Non-controlling interest		71	73
TOTAL EQUITY		13,478	9,131
TOTAL LIABILITIES AND EQUITY		575,585	508,935

These financial statements were approved by the Board and authorised for issue on 23 April 2012:
Signed on behalf of the Board

Director CDS BRYCE

The notes on pages 20 to 93 form an integral part of the financial statements.

CONSOLIDATED STATEMENT OF CASH FLOWS
Year ended 31 December 2011

	Note	2011 $millions	2010 $millions
NET CASH FLOWS USED IN OPERATING ACTIVITIES	23(b)	(2,300)	(4,347)
INVESTING ACTIVITIES			
Purchase of property, plant and equipment	13	(3)	(1)
Purchase of available-for-sale financial assets	12	-	(7)
Dividends received from available-for-sale financial assets		-	56
Proceeds from sale of available-for-sale financial assets		1	10
Proceeds from sale of joint venture	14	28	-
NET CASH FLOWS FROM INVESTING ACTIVITIES		26	58
FINANCING ACTIVITIES			
Issue of ordinary shares	21	5,386	-
(Repayment) / issue of equity preference shares	21	(1,500)	2,500
Dividends paid to preference shareholders of the Company	22	(18)	(21)
Repayment of preference shares classified as debt	17	(786)	-
Repayments of subordinated loans		-	(644)
Interest paid on subordinated loan liabilities		(125)	(142)
Dividends paid to equity holders of the Company	22	(110)	(401)
Capital repayment to non-controlling interests		-	(2)
NET CASH FLOWS GENERATED IN FINANCING ACTIVITIES		2,847	1,290
NET INCREASE / (DECREASE) IN CASH AND CASH EQUIVALENTS		573	(2,999)
Currency translation differences on foreign currency cash balances		107	(79)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR		10,376	13,454
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	23(a)	11,056	10,376

The notes on pages 20 to 93 form an integral part of the financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2011

1. CORPORATE INFORMATION

The principal activity of the Group is the provision of financial services to corporations, governments, and financial institutions. 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 Company is a public limited company incorporated and domiciled in England and Wales, with its registered office at: 25 Cabot Square, Canary Wharf, London, E14 4QA. The Company is authorised and regulated by the Financial Services Authority ("FSA").

2. BASIS OF PREPARATION

a. Statement of compliance

The Group has prepared its annual consolidated financial statements in accordance with International Financial Reporting Standards ("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 United Kingdom Companies Act 2006. The primary consolidated financial statements in this document are presented in accordance with International Accounting Standards ("IAS") 1 *'Presentation of financial statements'*.

b. New standards and interpretations adopted during the year

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

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

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

As part of the May 2010 improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 3 *'Business combinations'* and IAS 27 *'Consolidated and separate financial statements'* (for application in annual periods beginning on or after 1 July 2010), and IFRS 7 *'Financial instruments: Disclosures'* and IAS 1 *'Presentation of financial statements'* (for application in annual periods beginning on or after 1 January 2011). The improvements were endorsed by the EU in February 2011.

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

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

2. BASIS OF PREPARATION (CONTINUED)

c. New standards and interpretations not yet adopted

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

An amendment to IAS 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.

An amendment to IAS 12 *'Income taxes'* was issued by the IASB in December 2010 for retrospective application in annual periods beginning on or after 1 January 2012.

An amendment to IAS 19 *'Employee benefits'* was issued by the IASB in June 2011 for retrospective application in annual periods beginning on or after 1 January 2013.

IAS 27 *'Consolidated and separate financial statements'* and IAS 28 *'Investment in associates and joint ventures'* were revised by the IASB in May 2011, for application in 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 – 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.

A further 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, including interim 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.

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.

d. Basis of measurement

The financial statements of the Group are prepared under the historical cost convention modified by the inclusion of certain financial instruments at fair value.

e. 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 consolidated financial statements and related disclosures. The Group believes that the estimates utilised in preparing the consolidated financial statements are reasonable, relevant and reliable. Actual results could differ from these estimates.

2. BASIS OF PREPARATION (CONTINUED)

f. Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of the Company and its subsidiaries made up to 31 December 2011. The financial statements for the subsidiaries are prepared for the same reporting year as the Group, using consistent accounting policies. The financial statements of subsidiaries which are presented in currencies other than US dollars are translated into US dollars as described in note 3(b). Subsidiaries are consolidated from the date that the Group gains control until the date that control ceases.

Intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions are eliminated in preparing the consolidated financial statements.

Non-controlling interests represent the portion of profit or loss and net assets not owned, directly or indirectly, by the Group and are presented separately in the income statement, consolidated statement of comprehensive income and within equity in the consolidated statement of financial position, separately from parent shareholders' equity. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the identifiable net assets.

g. The going concern assumption

The Group's business activities, together with the factors likely to affect its future development, performance and position, are set out in the Business Review sections of the Director's Report on pages 1 to 10. In addition, the notes to the financial statements include the Group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments; and its exposures to credit risk and liquidity risk.

As set out in the Directors' report retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Group's strategy and steps have been taken to strengthen both the Morgan Stanley Group and the Group's capital positions.

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 annual report and financial statements.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Functional currency

Items included in the consolidated financial statements are measured and presented in US dollars, the currency of the primary economic environment in which the Group operates.

All currency amounts in the consolidated financial statements and Directors' Report are rounded to the nearest million US dollars.

b. Foreign currencies

All monetary assets and liabilities denominated in currencies other than US dollars are translated into US dollars at the rates ruling at the date of the consolidated statement of financial position. Assets and liabilities of foreign operations are translated into US dollars using the closing rate method. Transactions in currencies other than US dollars are recorded at the rates prevailing at the dates of the transactions. Translation differences arising from the net investments in the foreign operations are taken to the 'Currency translation reserve'. Foreign exchange differences on available-for-sale financial assets are recorded in the 'Fair value reserve' in equity, with the exception of translation differences on the amortised cost of monetary available-for-sale financial assets, which are recognised through the consolidated income statement. All other translation differences are taken through the consolidated income statement. Exchange differences recognised in the consolidated income statement are presented in 'Other income' or 'Other expense', except where noted in 3(c) below.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

b. Foreign currencies (continued)

On disposal of a foreign operation, the related cumulative gain or loss in the 'Currency translation reserve' attributable to the equity holders of the Group is reclassified to the consolidated income statement as a gain or loss on disposal of subsidiary. On liquidation of a foreign operation, the related cumulative gain or loss in the 'Currency translation reserve' attributable to the equity holders of the Group is reclassified to retained earnings.

c. Financial instruments

The Group classifies its financial assets in the following categories on initial recognition: financial assets classified as held for trading, financial assets designated at fair value through profit or loss, available-for-sale financial assets, and loans and receivables.

The Group classifies its financial liabilities into the following categories on initial recognition: financial liabilities classified as held for trading, financial liabilities designated at fair value through profit or loss, and financial liabilities at amortised cost.

More information regarding these classifications is included below:

(i) Financial instruments classified as held for trading

With the exception of loans, financial instruments classified as held for trading, including all derivatives, are initially recorded on trade date at fair value (see note 3(d) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends are reflected in the consolidated income statement in 'Net gains / (losses) on financial instruments classified as held for trading'.

For loans classified as held for trading, from the date a loan's terms are agreed (trade date), until the loan is funded (settlement date), the Group recognises any unrealised fair value changes in the loan as financial instruments classified as held for trading. On settlement date, the fair value of consideration given is recognised as a financial asset classified as held for trading. All subsequent changes in fair value, foreign exchange differences and interest are reflected in the consolidated income statement in 'Net gains / (losses) from financial instruments classified as held for trading'.

For all financial instruments classified as held for trading, transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated income statement in 'Other expense'.

(ii) Financial instruments designated at fair value through profit or loss

The Group has designated certain financial assets and financial liabilities at fair value through profit or loss when:

- the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation at fair value eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

From the date the transaction in a financial instrument designated at fair value is entered into (trade date) until settlement date, the Group recognises any unrealised fair value changes in the contract as financial instruments designated at fair value through profit or loss. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at fair value through profit or loss (see note 3 (d) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends, are reflected in the consolidated income statement in 'Net gains / (losses) on financial instruments designated at fair value through profit or loss'. Transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated income statement in 'Other expense'.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

(iii) Available-for-sale financial assets

Financial assets classified as available-for-sale are non-derivative financial assets that are either designated in this category or not classified in any of the other categories of financial instruments. Financial assets classified as available-for-sale are recorded on trade date and are initially recognised and subsequently measured at fair value (see note 3 (d) below).

For debt instruments, interest is calculated using the effective interest method (see note 3 (c)(iv) below), impairment losses and reversals of impairment losses and foreign exchange differences on the amortised cost of the asset are recorded in the consolidated income statement in 'Net gains / (losses) on available-for-sale financial assets'. For equity instruments, dividend income and impairment losses are recorded in the consolidated income statement in 'Net gains / (losses) on fixed asset investments in available-for-sale financial assets'. All other gains and losses on debt and equity instruments classified as available-for-sale are recognised in the 'Fair value reserve' within equity.

Transaction costs that are directly attributable to the acquisition of the available-for-sale financial asset are added to the fair value on initial recognition.

On disposal or impairment of an available-for-sale financial asset, the cumulative gain or loss in the 'Fair value reserve' is transferred to and recognised in the consolidated income statement and reported in 'Net gains / (losses) on available-for-sale financial assets'.

(iv) Loans and receivables and financial liabilities at amortised cost

Financial assets classified as loans and receivables are initially recognised on settlement date at fair value (see note 3 (d) below) and subsequently measured at amortised cost less allowance for impairment. Interest is recognised in the consolidated income statement in 'Interest income', using the effective interest rate method as described below. Transaction costs that are directly attributable to the acquisition of the financial asset are added to or deducted from the fair value on initial recognition. Impairment losses and reversals of impairment losses on financial assets classified as loans and receivables are recognised in the consolidated income statement in 'Other expense'.

Financial liabilities held at amortised cost are initially recognised on settlement date at fair value (see note 3 (d) below) and subsequently measured at amortised cost. Interest is recognised in the consolidated income statement in 'Interest expense' using the effective interest rate method as described below. Transaction costs that are directly attributable to the issue of the financial liability are added to or deducted from the fair value on initial recognition.

The effective interest rate method is a method of calculating the amortised cost of a financial asset or financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the expected life of the financial asset or financial liability. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability (or, where appropriate a shorter period) to the carrying amount of the financial asset or financial liability. The effective interest rate is established on initial recognition of the financial asset and liability. The calculation of the effective interest rate includes all fees and commissions paid or received, transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability.

In the course of financing its business and as part of its trading activities, the Group enters into arrangements which involve the sale of securities with agreements to repurchase, the purchase of securities with resale agreements, the lending of securities with collateral received and the borrowing of securities with collateral given. Cash collateral balances repayable and accrued interest arising under repurchase agreements and securities lending arrangements are classified as 'Financial liabilities at amortised cost' and the related securities, where owned by the Group, are included in 'Financial assets classified as held for trading'. Cash collateral balances receivable and accrued interest arising under resale agreements and securities borrowing arrangements are classified as 'Loans and receivables'. Securities received by the Group under resale arrangements and securities borrowing arrangements are generally not recognised on the consolidated statement of financial position.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

(iv) Loans and receivables and financial liabilities at amortised cost (continued)

The redeemable preference shares issued by the Group were classified as financial liabilities at amortised cost in accordance with the substance of the contractual arrangement. Dividends on these redeemable preference shares were recognised in the consolidated income statement in 'Interest expense' using the effective interest rate method.

d. Fair value of financial instruments

Fair value measurement

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

In determining fair value, the Group uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that maximises the use of relevant observable inputs and minimises the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Group. Unobservable inputs are inputs that reflect the Group's assumptions about the assumptions other market participants would use in pricing the asset or liability, developed based on the best information available in the circumstances.

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

The Group uses prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments.

Valuation techniques

Fair value for many cash and OTC contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity), as well as multiple inputs including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk. Adjustments for liquidity risk adjust model-derived valuations of financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trader activity, broker quotes or other external third-party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions. Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty's credit spreads is considered when measuring the fair value of assets. For OTC derivatives, the impact of changes in both the Group's and the counterparty's credit standing is considered when measuring fair value.

In determining the expected exposure the Group simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party credit default swap ("CDS") spread data. Where CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. The Group also considers collateral held and legally enforceable master netting agreements that mitigate the Group's exposure to each counterparty. Adjustments for model uncertainty are taken for positions where underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value of financial instruments (continued)

Valuation techniques (continued)

The Group generally subjects all valuations and models to a review process initially and on a periodic basis thereafter. The Group may apply a concentration adjustment to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk exposure. Where possible, these adjustments are based on observable market information but in many instances significant judgment is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

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

Gains and losses on inception

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group recognises a gain or loss on inception of the transaction.

When unobservable market data has a significant impact on determining fair value at the inception of the transaction, the entire initial gain or loss indicated by the valuation technique as at the transaction date is not recognised immediately in the consolidated income statement and is recognised instead when the market data becomes observable.

e. Impairment of financial assets

At each reporting date, an assessment is made as to whether there is any objective evidence of impairment in the value of a financial asset classified as either available-for-sale or loans and receivables. Impairment losses are recognised if an event has occurred which will have an adverse impact on the expected future cash flows of an asset and the expected impact can be reliably estimated.

Impairment losses on available-for-sale financial assets are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value. When a decline in the fair value of an available-for-sale financial asset has been recognised through the consolidated statement of comprehensive income and there is evidence that the asset is impaired, the cumulative loss that had been recognised through the consolidated statement of comprehensive income is removed from reserves and recognised in the consolidated income statement within 'Net gains / (losses) on available-for-sale financial assets'.

Impairment losses on loans and receivables carried at amortised cost are measured as the difference between the carrying amount of the financial asset and the present value of estimated cash flows discounted at the asset's original effective interest rate. Such impairment losses are recognised in the consolidated income statement within 'Other expense' and are reflected against the carrying amount of the impaired asset on the consolidated statement of financial position. Interest on the impaired asset continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset.

Subsequent increases in fair value of previously impaired equity available-for-sale financial assets are reported as fair value gains in the consolidated statement of comprehensive income and not separately identified as an impairment reversal. For all other financial assets, if in a subsequent year, the amount of the estimated impairment loss decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed as detailed by financial asset in note 3 (c)(iii) and (iv). Any reversal is limited to the extent that the value of the asset may not exceed the original amortised cost of the asset had no impairment occurred.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

f. Impairment of non-financial assets

Non-financial assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units). Non-financial assets, other than goodwill, that have suffered an impairment are reviewed for possible reversal of the impairment at the end of each reporting period.

g. Fees and commissions

Fees and commissions classified within 'Other income' in the consolidated income statement include account servicing fees, investment management fees, sales commissions, placement fees, advisory fees and syndication fees. Fees and commissions classified within 'Other expense' include transaction and service fees. These amounts are recognised as the related services are performed or received.

h. Property, plant and equipment

Property, plant and equipment are stated at cost net of depreciation and any provision for impairment in value, which are included within 'Other expense' in the consolidated income statement. For assets in the course of construction, interest that is directly attributable to the construction of the qualifying asset is capitalised as a cost of the asset. The interest capitalisation rate is based on the Morgan Stanley Group's blended funding rates.

For premises held under operating leases, a reinstatement provision is recognised for the estimated cost to reinstate the premises at the end of the lease period. When the reinstatement provision is established and included within 'Provisions' in the consolidated statement of financial position, an equivalent asset is recognised and included in the cost of leasehold improvements at the initial present value of any reinstatement obligations. The discount effect included in the reinstatement provision is reversed over time using a constant effective yield method and included within 'Interest expense' in the consolidated income statement. The reinstatement asset is depreciated over the useful economic life of the relevant leasehold improvement asset and the depreciation charge is included within 'Other expense'.

Depreciation is provided on property, plant and equipment at rates calculated to write off the cost of the assets on a straight line basis over their expected useful lives as follows:

Leasehold improvements	- shorter of remaining lease term and 25 years
Fixtures, fittings and equipment	- 3 to 8 years

i. Cash and cash equivalents

For the purposes of the statement of cash flows, cash and cash equivalents comprises cash and demand deposits with banks, net of outstanding bank overdrafts, along with highly liquid investments, with original maturities of three months or less, that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

j. Investment in joint venture

The Group's investment in its joint venture is accounted for using the equity method of accounting.

Under the equity method, the investment in the joint venture is recognised in the consolidated statement of financial position at cost, including attributable goodwill, and is adjusted for post-acquisition changes in the Group's share of total assets less total liabilities of the joint venture. The Group's share of its joint ventures' post-acquisition profits or losses is recognised in the consolidated income statement; its share of post-acquisition movements in other comprehensive income is recognised in other comprehensive income within the consolidated statement of comprehensive income. Losses are only recognised in excess of the investment where the Group has incurred legal or constructive obligations or made payments on behalf of the joint venture. Profits and losses resulting from transactions between the Group and the joint venture are eliminated to the extent of the interest in the joint venture. Distributions received from the joint venture reduce the carrying amount of the investment.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

k. Income tax

The tax expense represents the sum of the tax currently paid and payable, and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit may differ from net profit as reported in the consolidated income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date. Current tax is charged or credited in the consolidated income statement, except when it relates to items charged or credited directly to other comprehensive income or equity, in which case the current tax is also dealt with in other comprehensive income or equity respectively.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the consolidated financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and associates, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each reporting date and limited to the extent that it is probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised. Deferred tax is charged or credited in the consolidated income statement, except when it relates to items charged or credited directly to other comprehensive income or equity, in which case the deferred tax is dealt with in other comprehensive income or equity, respectively.

Current tax assets are offset against current tax liabilities and deferred tax assets are offset against deferred tax liabilities when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Group intends to settle its current tax assets and current tax liabilities on a net basis.

l. Operating leases

Rentals payable under operating leases are charged to 'Other expense' in the consolidated income statement on a straight line basis over the lease term. Lease incentives are allocated on a straight line basis over the lease term as a reduction to rental expense.

Rentals receivable under operating leases are credited to 'Other income' in the consolidated income statement on a straight line basis over the lease term. Initial direct costs incurred in negotiating and arranging the lease are added to the carrying amount of the leased asset and recognised in the consolidated income statement on a straight line basis over the lease term. Lease incentives are allocated on a straight line basis over the lease term.

m. Provisions

Provisions are recognised when the Group has a present obligation as a result of a past event, when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and when a reliable estimate can be made of the amount of the obligation.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

n. Employee compensation plans

(i) Equity-settled share based compensation plans

Morgan Stanley operates equity based compensation plans on behalf of the Group and, in relation to which, the Group pays Morgan Stanley in consideration of the procurement of the transfer of shares to employees. The cost of equity based transactions with employees is measured based on the fair value of the equity instruments at grant date. Fair value of stock unit awards is based on the market price of Morgan Stanley shares and fair value of stock option awards is estimated using the Black-Scholes option pricing model, which takes into account the option's exercise price, its expected term, the risk free interest rate and the expected volatility of the market price of Morgan Stanley shares. Non-market vesting conditions are not taken into account when measuring fair value, but are reflected by adjusting over time the number of equity instruments included in the measurement of the transaction such that the amount ultimately recognised reflects the number that actually vest. The expense for IFRS 2 *'Share-based payments'* ("IFRS 2") purposes is taken directly to 'Other expense' in the consolidated income statement; the corresponding credit to reserves is reduced to the extent that payments are due to Morgan Stanley in respect of these awards.

(ii) Other deferred compensation plans

Morgan Stanley also maintains deferred compensation plans for the benefit of certain employees that provide a return to the participating employees based upon the performance of various referenced investments. Liabilities for these awards, which are included within 'Accruals and deferred income' in the consolidated statement of financial position, are measured at fair value and recognised over time in accordance with the awards' vesting conditions. The related expense is recorded within 'Staff costs' in 'Other expense'. The Group economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivatives are recognised within 'Financial instruments classified as held for trading' in the consolidated statement of financial position and the related gains and losses are recorded within 'Net gains / (losses) on financial instruments classified as held for trading' in the consolidated income statement.

o. Retirement benefits

The Group operates defined contribution and defined benefit retirement plans.

Contributions due in relation to the Group's defined contribution retirement plan are recognised in 'Other expense' in the consolidated income statement when payable.

For the Group's defined benefit retirement plan, the plan obligations are measured on an actuarial basis in accordance with the advice of an independent qualified actuary using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the plan liabilities. Plan assets are measured at their fair value at the reporting date. A surplus or deficit of plan assets over liabilities is recognised in the consolidated statement of financial position as an asset or a liability respectively. The value of any asset recognised is restricted to the sum of any unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan. The current service cost and any past service costs together with the expected return on plan assets less the unwinding of the discount on the plan liabilities is charged to 'Other expense' in the consolidated income statement. Actuarial gains and losses that arise in calculating the Group's obligation in respect of a plan are recognised in other comprehensive income, in the period in which they occur.

4. INTEREST INCOME AND INTEREST EXPENSE

'Interest income' and 'Interest expense' represent total interest income and total interest expense for financial assets and financial liabilities that are not carried at fair value.

No other gains or losses have been recognised in respect of loans and receivables other than as disclosed as 'Interest income' within the consolidated income statement.

No other gains or losses have been recognised in respect of financial liabilities measured at amortised cost other than as disclosed as 'Interest expense' within the consolidated income statement.

Interest expense includes a dividend of $18 million paid on the Class B preference shares, which were classified as debt, during the year (2010: $21 million).

5. OTHER INCOME

	2011 $millions	2010 $millions
Fee and commission income		
Advisory fees	151	108
Trust and other fiduciary activities	114	76
Foreign exchange gains	-	4
	265	188

6. OTHER EXPENSE

	2011 $millions	2010 $millions
Fee and commission expense:		
Brokerage fees	508	437
Direct staff costs	182	170
Management recharges relating to staff costs borne by other Morgan Stanley Group undertakings	1,511	1,492
Bank payroll tax	-	239
Bank levy	43	-
Management recharges from other Morgan Stanley Group undertakings relating to other services	281	306
Operating lease rentals	5	9
Depreciation on property, plant and equipment	4	5
Foreign exchange losses	30	-
Administration and corporate services	453	418
Auditor's remuneration:		
Audit fees:		
Audit of the Company's financial statements	3	3
Audit of subsidiaries' financial statements	1	1
Fees for other services:		
Other	-	-
Other operating expense	272	273
	3,293	3,353

Included within both direct staff costs and management recharges relating to staff costs borne by other Morgan Stanley Group undertakings is an amount of $185 million (2010: $170 million) in relation to equity-settled share-based compensation plans, granted to employees of the Group. These costs reflect the amortisation of equity-based awards granted to employees over the last three years and are therefore not directly aligned with other staff costs in the current year. Also included within direct staff costs and management recharges relating to staff costs borne by other Morgan Stanley Group undertakings is an amount of $62 million (2010: $59 million) in relation to defined contribution pension plans.

Fees payable to the Company's auditors for non-audit services are $300,000 (2010:$160,000).

6. OTHER EXPENSE (CONTINUED)

The average number of employees of the Group including the Directors, is analysed below:

	2011 Number	2010 Number
Company and institutional securities infrastructure	160	157
Business units and other	210	197
	370	354

The costs of staff are analysed below:

	2011 $millions	2010 $millions
Wages and salaries, including termination costs	160	150
Social security costs	17	15
Pension costs	5	5
	182	170

The Group paid no remuneration to the Company's Directors during the current or prior year but incurred management recharges in respect of Directors' services provided to the Group. The amount of remuneration received by Directors in respect of their services to the Group is disclosed in note 35.

7. INCOME TAX EXPENSE

The Company and its subsidiary undertakings in the United Kingdom ("UK") provide for UK corporation tax at 26.49% (2010: 28%). Overseas subsidiary undertakings provide for taxation at the appropriate rates in the countries in which they operate.

	2011 $millions	2010 $millions
Current tax expense		
United Kingdom corporation tax charge		
– current year	249	463
– adjustments in respect of prior years	(53)	(36)
Double taxation relief		
– current year	(77)	(63)
– adjustments in respect of prior years	(46)	(12)
Overseas tax		
– current year	181	165
– adjustment in respect of prior years	1	5
	255	522
Deferred tax expense		
Origination and reversal of temporary differences	(2)	(8)
Adjustment in respect of prior years	(2)	2
Effect of changes in tax rates	1	-
	252	516

7. INCOME TAX EXPENSE (CONTINUED)

Reconciliation of effective tax rate

The current year income tax expense is higher than that resulting from applying the average standard rate of corporation tax in the UK of 26.49% (2010: 28%). The main differences are explained below:

	2011 $millions	2010 $millions
Profit before income tax	825	763
Income tax using the average standard rate of corporation tax in the UK of 26.49% (2010: 28%)	219	214
Impact on tax of:		
Expenses not deductible for tax purposes:		
UK bank levy	11	-
Bank payroll tax	-	67
Other expenses	3	4
Interest not deductible for tax purposes:		
Preference share dividends shown as interest expense	5	6
Other interest expense	2	2
Group relief surrendered for nil cash consideration	150	146
Effect of tax rates in foreign jurisdictions	1	3
Utilisation of prior year tax losses	(14)	(2)
Tax under / (over) provided in prior years	12	(44)
Tax exempt income	(13)	1
Withholding tax expensed	-	(3)
(Utilisation) / creation of tax reserves in respect of prior years	(111)	118
Currency translation on taxes	(6)	-
Other	(7)	4
Total income tax expense in the consolidated income statement	252	516

The Group has a policy of surrendering tax-deductible losses ('group relief') for nil consideration to other members of the Morgan Stanley UK tax group. Within the Group, a number of subsidiary undertakings generate tax-deductible losses which are surrendered to other Morgan Stanley subsidiary undertakings outside the Group.

Finance (No. 2) Act 2010 enacted a 1% reduction in the UK corporation tax rate to 27% with effect from April 2011. Finance Act 2011 enacted a further 1% reduction in the rate of UK corporation tax to 26% from April 2011. The combined 2% reduction in the tax rate impacted the current tax charge in 2011.

Finance Act 2011 enacted an additional 1% reduction to the UK corporation tax rate to 25% with effect from April 2012. In the Budget announcement on the 21 March 2012, this reduction was increased to 2% and was substantively enacted on 26 March 2012. The combined 2% reduction in the tax rate to 24% from 1 April 2012 will impact the current tax charge in 2012.

7. INCOME TAX EXPENSE (CONTINUED)

In addition to the amount charged to the consolidated income statement, the aggregate amount of current and deferred tax relating to each component of other comprehensive income was as follows:

	2011 Before tax $millions	2011 Tax benefit / (expense) $millions	2011 Net of tax $millions	2010 Before tax $millions	2010 Tax benefit / (expense) $millions	2010 Net of tax $millions
Foreign currency translation differences on foreign operations	(17)	3	(14)	(30)	2	(28)
Fair value reserve:						
Net change in fair value of available-for-sale assets	24	(6)	18	1	-	1
Actuarial gains / (losses) on defined benefit pension plans	2	-	2	(3)	-	(3)
Other comprehensive income / (loss)	9	(3)	6	(32)	2	(30)

8. CASH AT BANK

Included within cash at bank is an amount of $8,171 million (2010: $7,238 million) which represents segregated client money, held in accordance with the FSA's Client Money Rules, and an amount of $8 million (2010: $40 million) which represents other client money.

9. OTHER RECEIVABLES

	2011 $millions	2010 $millions
Amounts held at exchanges	160	193
Amounts due from other Morgan Stanley Group undertakings	5,165	10,758
Other	1,900	2,616
	7,225	13,567

10. 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.

	2011 Assets $millions	2011 Liabilities $millions	2010 Assets $millions	2010 Liabilities $millions
Fair value				
Government debt securities	9,249	10,193	16,371	15,105
Corporate and other debt	12,474	2,727	22,096	4,721
Corporate equities	22,282	14,762	46,188	14,029
Derivatives	310,138	306,143	186,339	186,938
	354,143	333,825	270,994	220,793

11. FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

Financial instruments designated at fair value through profit or loss consist primarily of the following financial assets and financial liabilities:

Prepaid over the counter ("OTC") contracts: The risk on these financial instruments, both financial assets and financial liabilities, is primarily hedged using financial instruments classified as held for trading including equity securities and interest rate swaps. These prepaid OTC contracts are designated at fair value as such contracts, as well as the financial instruments with which they are hedged, are risk managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis.

Issued structured notes: These relate to financial liabilities which arise from selling structured products generally in the form of notes or certificates. These structured notes are designated at fair value as the risks to which the Group is a contractual party are risk managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis.

Corporate loans: Certain loans to customers are designated at fair value because either the risks of the loans have been matched with other fair valued financial instrument contracts and such a designation reduces an accounting mismatch; or as part of a documented risk management strategy the risks of the loan are managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis; or because the loan contract itself contains an embedded derivative that must otherwise be separated and measured at fair value.

Other financial assets and liabilities: These include financial assets and liabilities such as those that arise upon the consolidation of certain special purpose entities and those that arise as a result of continuing recognition of certain financial assets and the simultaneous recognition of an associated financial liability. These financial assets and liabilities are designated at fair value as the risks to which the Group is a contractual party are risk managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis.

	2011 Assets $millions	2011 Liabilities $millions	2010 Assets $millions	2010 Liabilities $millions
Prepaid OTC contracts	3,264	2,676	4,909	3,708
Structured notes	-	1,099	-	492
Corporate loans	1,377	-	-	-
Other financial assets and liabilities	3,921	7,935	4,450	9,513
	8,562	11,710	9,359	13,713

The maximum exposure to credit risk of loans and receivables designated at fair value through profit or loss at the end of the year is $1,377 million (2010: $nil). The cumulative change in fair value of loans attributable to changes in credit risk amounts to a gain of $85 million (2010: $nil). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk.

The change in fair value recognised through the consolidated income statement attributable to own credit risk is a gain of $128 million (2010: $1 million loss) and cumulatively is $249 million gain (2010: $121 million gain). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk.

The carrying amount of financial liabilities designated at fair value was $144 million lower than the contractual amount due at maturity (2010: $8 million lower).

12. AVAILABLE-FOR-SALE FINANCIAL ASSETS

Financial assets that are categorised as available-for-sale consist of corporate equities.

Movement in available-for-sale financial assets	**2011 $millions**	**2010 $millions**
At the beginning of the year	44	43
Additions	-	7
Changes in fair value		
- recognised in the fair value reserve	24	4
Disposals	(1)	(10)
At the end of the year	67	44

Included in 'Available-for-sale financial assets' are listed investments of $2 million (2010: $4 million).

13. PROPERTY, PLANT AND EQUIPMENT

	Leasehold improvements $millions	**Fixtures, fittings and equipment $millions**	**Total $millions**
2011			
Cost			
At 1 January 2011	24	21	45
Additions	-	3	3
Foreign exchange revaluation	(1)	(1)	(2)
At 31 December 2011	23	23	46
Depreciation			
At 1 January 2011	16	17	33
Charge for the year	2	2	4
Foreign exchange revaluation	-	(1)	(1)
At 31 December 2011	18	18	36
Net book value			
At 31 December 2011	5	5	10
2010			
Cost			
At 1 January 2010	24	21	45
Additions	-	1	1
Disposals	-	(1)	(1)
At 31 December 2010	24	21	45
Depreciation			
At 1 January 2010	13	16	29
Charge for the year	3	2	5
Disposals	-	(1)	(1)
At 31 December 2010	16	17	33
Net book value			
At 31 December 2010	8	4	12

14. JOINT VENTURE

During the year, the Group sold its interest in Tarvos Investments GmbH ("Tarvos"), a limited liability company incorporated in Germany. The Group had contributed 50% of the capital in the company and accounted for the investment using the equity method of accounting as the majority of the risks and rewards of the company were absorbed by entities outside the Group.

The sale of Tarvos resulted in a net gain of $21 million reported in the consolidated income statement, calculated as the difference between the proceeds of $28 million and the carrying value of the investment at disposal of $7 million.

15. OTHER PAYABLES

	2011 $millions	2010 $millions
Amounts owing to other Morgan Stanley Group undertakings	17,849	21,442
Other	3,858	3,115
	21,707	24,557

16. SUBORDINATED LOANS

The amounts subject to subordinated loan agreements are wholly repayable as shown below:

Counterparty	Repayment Date	Interest Rate	2011 $millions	2010 $millions
Morgan Stanley International Finance S.A.	31 October 2025	LIBOR plus 1.25%	-	7,906
Morgan Stanley UK Financing I LP	31 October 2025	LIBOR plus 1.25%	7,906	-
			7,906	7,906

All amounts outstanding under subordinated loan agreements are repayable at any time at the Group's option, subject to two business days' notice to the lender and at least one month notice to the Financial Services Authority ("FSA"), which has the right under the agreement to refuse consent to repayment.

On 16 December 2011 Morgan Stanley International Finance S.A. novated the subordinated debt held by the Group to Morgan Stanley UK Financing I LP.

The Group has not defaulted on principal, interest or made any other breaches with respect to its subordinated loans during the year.

17. PREFERENCE SHARES

	Class B non-cumulative preference shares of $1 each: $millions
Allotted and fully paid:	
At 1 January 2011	786
Repurchased	(786)
31 December 2011	-

At 31 December 2010 the Group's issued share capital included 785,772,500 Class B non-cumulative preference shares of $1 each, classified as liabilities. On 22 December 2011 the Group repurchased the preference shares.

During the year, dividends of $18 million (2010: $21 million) were paid to the holders of the Class B redeemable non-cumulative preference shares.

18. PROVISIONS

	Property $millions	Litigation $millions	Total $millions
At 1 January 2011	3	26	29
Additional provisions	1	6	7
Provisions utilised	-	(24)	(24)
Unused provisions reversed	-	(3)	(3)
Foreign exchange revaluation	-	1	1
At 31 December 2011	4	6	10

Property

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Property, plant and equipment' (note 13).

Litigation matters

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 any individual proceedings where the Group believes a material loss to be reasonably possible and reasonably estimable, there can be no assurance that material losses will not be incurred from claims that have not yet been notified to the Group or are not yet determined to be probable or possible and reasonably estimable.

On 25 August 2008, the Morgan Stanley Group, the Group and two ratings agencies were named as defendants in a purported class action related to securities issued by a structured investment vehicle ("SIV") called Cheyne Finance (the "Cheyne SIV"). The case is styled *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.* and is pending in the Southern District of New York ("SDNY"). The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. On 2 September 2009, the court dismissed all of the claims against the Morgan Stanley Group and the Group except for plaintiffs' claims for common law fraud. On 15 June 2010, the court denied plaintiffs' motion for class certification. On 20 July 2010, the court granted plaintiffs leave to replead their aiding and abetting common law fraud claims against the Morgan Stanley Group and the Group, and those claims were added in an amended complaint filed on 5 August 2010. On 27 December 2011, the court permitted plaintiffs to reinstate their causes of action for negligent misrepresentation and breach of fiduciary duty against the Morgan Stanley Group and the Group. The Morgan Stanley Group and the Group moved to dismiss these claims on 10 January 2012. On 5 January 2012, the court permitted plaintiffs to amend their Complaint and assert a negligence claim against the Morgan Stanley Group and the Group. The amended complaint was filed on 9 January 2012 and the Morgan Stanley Group and the Group moved to dismiss the negligence claim on 17 January 2012. On 23 January 2012, the Morgan Stanley Group and the Group moved for summary judgment with respect to the fraud and aiding and abetting fraud claims. There are 15 plaintiffs in this action asserting claims related to approximately $983 million of securities issued by the Cheyne SIV. Plaintiffs have not alleged the amount of their alleged investments and are seeking, among other things, unspecified compensatory and punitive damages. Based on currently available information, the Morgan Stanley Group and the Group believes that the defendants could incur a loss up to the amount of plaintiffs' claimed compensatory damages, once specified, related to their alleged purchase of approximately $983 million of securities issued by the Cheyne SIV plus pre- and post-judgment interest, fees and costs.

18. PROVISIONS (CONTINUED)

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Morgan Stanley Group, which is styled *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al.* and is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a $275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Morgan Stanley Group misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Morgan Stanley Group knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately $228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional $12 million, punitive damages, equitable relief, fees and costs. On 28 February 2011, the court presiding over this action denied the Morgan Stanley Group's motion to dismiss the complaint. On 21 March 2011, the Morgan Stanley Group appealed the order denying its motion to dismiss the complaint. On 7 July 2011, the appellate court affirmed the lower court's decision denying the motion to dismiss. Based on currently available information, the Morgan Stanley Group believes it could incur a loss of up to approximately $240 million plus pre- and post-judgment interest, fees and costs.

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

In addition to the above the Group has identified the following proceeding.

On 10 June 2010, the Morgan Stanley Group and the Group was named as a new defendant in a pre-existing purported class action related to securities issued by a SIV called Rhinebridge plc ("Rhinebridge SIV"). The case is styled *King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al.* and is pending in the SDNY. The complaint asserts claims for common law fraud and aiding and abetting common law fraud and alleges, among other things, that the ratings assigned to the securities issued by the SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime RMBS held by the SIV. On 15 July 2010, the Morgan Stanley Group and the Group moved to dismiss the complaint. That motion was denied on 29 October 2010. On 27 December 2011, the court permitted plaintiffs to amend their complaint and assert causes of action for negligence, negligent misrepresentation, and breach of fiduciary duty against the Morgan Stanley Group and the Group. The amended complaint was filed on 10 January 2012 and the Morgan Stanley Group and the Group moved to dismiss the negligence, negligent misrepresentation, and breach of fiduciary duty claims on 31 January 2012. The case is pending before the same judge presiding over the litigation concerning the Cheyne SIV, described above. While reserving their ability to act otherwise, plaintiffs have indicated that they do not currently plan to file a motion for class certification. Plaintiffs have not alleged the amount of their alleged investments, and are seeking, among other relief, unspecified compensatory and punitive damages.

19. DEFERRED TAX ASSETS AND LIABILITIES

Deferred taxes are calculated on all temporary differences under the liability method. The movement in the deferred tax account is as follows:

	2011		2010	
	Deferred tax asset $millions	Deferred tax liability $millions	Deferred tax asset $millions	Deferred tax liability $millions
At 1 January	48	(5)	47	(7)
Amount recognised in the consolidated income statement	3	1	4	2
Amount recognised in equity	(4)	(4)	(2)	-
Impact of tax rate changes	(2)	1	(1)	-
Foreign exchange adjustments	(1)	-	-	-
As at 31 December	44	(7)	48	(5)

The deferred tax included in the consolidated statement of financial position and changes recorded in the 'income tax expense' are as follows:

	Deferred tax asset 2011 $millions	Deferred tax liability 2011 $millions	Consolidated Income statement 2011 $millions	Deferred tax asset 2010 $millions	Deferred tax liability 2010 $millions	Consolidated Income statement 2010 $millions
Depreciation - temporary differences	6	-	1	7	-	-
Deferred compensation	27	-	(4)	24	-	6
Available-for-sale financial assets	-	(4)	-	1	-	-
Forecast currency hedges	-	(3)	(1)	-	(5)	-
Amounts not recognised due to unobservable market data	10	-	-	14	-	-
Other temporary differences	1	-	1	2	-	-
	44	(7)	(3)	48	(5)	6

The deferred tax assets recognised are based on management's assessment that it is probable that the Group will have taxable profits against which the temporary differences can be utilised.

19. DEFERRED TAX ASSETS AND LIABILITIES (CONTINUED)

Finance Act 2011 enacted a 1% reduction to the UK corporation tax rate to 25% with effect from April 2012. This rate reduction to 25% has had an impact on the Group's deferred tax balance as indicated above.

As part of the Budget announcements on 21 March 2012, a further 1% reduction in the rate of UK corporation tax to 24% was announced and substantively enacted on 26 March 2012. A further announcement to reduce the UK corporation tax rate to 23% and 22% from April 2013 and April 2014 respectively was also made. However, as these reductions were not substantively enacted as at 31 December 2011, the effect of these subsequent rate reductions has not been applied to the valuation of the Group's deferred tax assets and liabilities.

Deferred tax assets have not been recognised in respect of the following temporary differences at the end of the year:

	2011 $millions	2010 $millions
Unused tax losses	38	104
	38	104

The aggregate amount of temporary differences associated with investments in subsidiaries, branches and joint ventures, for which deferred tax liabilities have not been recognised is $nil (2010: $nil).

20. COMMITMENTS AND CONTINGENCIES

The Group has entered into non-cancellable commercial leases on premises and equipment. These leases have an average life of between three and five years. The leases on the premises include renewal options and escalation clauses in line with general rental market conditions and rent adjustments based on price indices. The lease agreements do not contain contingent rent payment clauses or purchase options and they do not impose any restrictions on the Group's ability to pay dividends, engage in debt financing transactions or enter into further lease agreements.

	2011 $millions	2010 $millions
Minimum lease payments under non-cancellable operating leases recognised as an expense in the year	5	9

Future minimum lease payments under non-cancellable operating leases at 31 December are due as follows:

	2011 $millions	2010 $millions
Within one year	9	7
In two to five years	13	19
Over five years	-	-
	22	26

At 31 December 2011 and 31 December 2010, the Group had the following outstanding commitments and contingent liabilities arising from off-balance sheet financial instruments:

	2011 $millions	2010 $millions
Contingent commitments	3,010	1,194
Financial guarantees	1	-
Underwriting commitments	156	128
Loan commitments	986	682
Forward starting reverse repurchase agreements	22,448	29,784
	26,601	31,788

21. EQUITY

Share capital

	Ordinary shares of $1 each: $millions	Ordinary shares of £1 each: $millions	Class A Ordinary shares of $1 each: $millions	Class C, non-cumulative, preference shares of $1 each: $millions	Class D, non-cumulative, preference shares of $1 each: $millions	Class D1, non-cumulative, preference shares of $0.4 each: $millions	Class D2, non-cumulative, preference shares of $0.6 each: $millions	Total shares: $millions
Issued and fully paid:								
At 1 January 2010	2,998	30	-	50	-	-	-	3,078
Issued in the year:								
29 November 2010	-	-	-	-	2,500	-	-	2,500
At 31 December 2010	2,998	30	-	50	2,500	-	-	5,578
Issued in the year:								
Subdivision of D preference shares	-	-	-	-	(2,500)	1,000	1,500	-
$1 ordinary shares issued	3,886	-	-	-	-	-	-	3,886
Class A Non-voting ordinary shares issued	-	-	1,500	-	-	-	-	1,500
D2 preference shares repurchased	-	-	-	-	-	-	(1,500)	(1,500)
At 31 December 2011	6,884	30	1,500	50	-	1,000	-	9,464
Voting Rights	69.59%	0.41%	Non-voting	20%	-	10%	-	100%

At 31 December 2011 the total issued share capital equated to $9,464 million (2010: $5,578 million) comprising 6,884,105,148 ordinary shares of $1 each, 17,615,107 ordinary shares of £1 each, 1,500,000,000 Class A Non-Voting ordinary shares of $1 each, 50,000,000 Class C non-redeemable non-cumulative preference shares of $1 each and 2,500,000,000 Class D1 non-cumulative voting preference shares of $0.4 each. All issued shares are fully paid.

The holders of the ordinary shares, irrespective of currency denomination, are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company in accordance with the Company's articles of association.

21. EQUITY (CONTINUED)

On 22 December 2011 the Company entered into the following transactions:

- The terms of the Class C non-redeemable non-cumulative $1 preference shares were amended so that the holders of such shares in issue shall carry 20% of the total voting rights of all the members of the Company having a right to attend and vote at general meetings.
- 2,500,000,000 non-redeemable non-cumulative D preference shares of $1 were subdivided into 2,500,000,000 D1 preference shares of $0.4 with 10% of the total voting rights and 2,500,000,000 D2 preference shares of $0.6 with no voting rights.
- 785,772,500 ordinary shares of $1 were issued, the proceeds of which were used to repurchase the 785,772,500 non-voting B preference shares previously classified as debt.
- 1,500,000,000 Class A non-voting ordinary shares of $1 were issued, the proceeds of which were used to repurchase the 2,500,000,000 non-voting D2 preference shares of $0.60.
- 3,100,000,000 ordinary shares of $1 were issued.

On a return of capital, the holders of the Class C and Class D non-redeemable non-cumulative preference shares shall rank in priority to the ordinary shares.

Currency translation reserve

The 'currency translation reserve' comprises all foreign exchange differences arising from the translation of the total assets less total liabilities of foreign operations.

The Group hedges foreign exchange exposure arising from its investments in foreign branch operations by utilising forward foreign currency exchange contracts (synthetic hedges) effected through intercompany accounts with the ultimate parent company, Morgan Stanley.

During the year, the Group disposed of two wholly owned subsidiaries, Archimedes Investments Ltd and Morgan Stanley Norton Investments, which were non-US dollar functional entities. As a consequence of the disposal, accumulated foreign exchange gains amounting to $5 million were reclassified from the 'currency translation reserve' to the consolidated income statement.

During the year, the Group liquidated a wholly owned subsidiary, Morgan Stanley Piccadilly Limited, a non-US dollar functional entity. As a consequence, the net assets of Morgan Stanley Piccadilly Limited were distributed to its parent company, Morgan Stanley & Co. International plc, and accumulated foreign exchange losses amounting to $11 million were reclassified from the 'currency translation reserve' to retained earnings.

Fair value reserve

The 'fair value reserve' includes the cumulative net change in the fair value of available-for-sale financial assets held at the reporting date. The tax effect of these movements is also included in the 'Fair value reserve'.

Capital contribution reserve

The 'Capital contribution reserve' comprises contributions of capital from the Group's parent company to subsidiaries of the Group.

Capital redemption reserve

The 'capital redemption reserve' represents transfers in prior years from retained earnings in accordance with relevant legislation.

22. DIVIDENDS

The following amounts represent the dividends paid in the current and prior year:

	2011		2010	
	Per Share $	Total $millions	Per Share $	Total $millions
Interim dividends on ordinary shares of £1 each	-	-	0.13	4
Interim dividends on ordinary shares of $1 each	-	-	0.13	396
Dividend on Class C preference shares	-	-	0.02	1
Dividend on Class D preference shares	0.04	110	-	-
Dividend on Class B preference shares	0.02	18	0.02	21
		128		422

The Directors have not recommended the payment of a final dividend out of the reserves available at 31 December 2011 (2010: $nil).

23. 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 from the date of acquisition:

	2011 $millions	2010 $millions
Cash at bank	11,180	10,436
Bank loans and overdrafts	(124)	(60)
	11,056	10,376

Included within 'Cash at bank' is $8,179 million (2010: $7,278 million) of segregated client funds that are not available for use by the Group. The corresponding payable is recognised and included in 'Trade payables' within 'Financial liabilities at amortised cost'.

23. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)

b. Reconciliation of cash flows from operating activities

	2011 $millions	2010 $millions
Profit for the year	573	247
Adjustments for:		
Depreciation on property, plant and equipment	4	5
Net gains on available-for-sale investments	-	(59)
Interest income	(4,003)	(3,852)
Interest expense	3,990	3,953
Income tax expense	252	516
Net gains on sale of joint venture	(21)	-
Other expenses	1	(3)
Profit before changes in operating assets and liabilities	796	807
Change in operating assets		
Net decrease / (increase) in loans and receivables	16,093	(41,074)
Net increase in financial assets classified as held for trading	(83,149)	(26,920)
Net decrease / (increase) in financial assets designated at fair value through profit or loss	797	(7,452)
	(66,259)	(75,446)
Change in operating liabilities		
Net (decrease) / increase in financial liabilities at amortised cost	(47,613)	47,416
Net increase in financial liabilities classified as held for trading	113,032	17,238
Net (decrease) / increase in financial liabilities designated at fair value through profit or loss	(2,003)	5,834
Net (decrease) / increase in provisions	(19)	7
	63,397	70,495
Effect of foreign exchange movements	(128)	51
Cash used in operating activities	(2,194)	(4,093)
Interest received	4,134	3,838
Interest paid	(3,853)	(3,807)
Income taxes paid	(387)	(285)
Net cash flows used in operating activities	(2,300)	(4,347)

24. EXPECTED MATURITY OF FINANCIAL ASSETS AND LIABILITIES

The table below shows an analysis of assets and liabilities analysed according to when they are expected to be recovered, realised or settled. Financial assets and liabilities classified as held for trading are excluded because they are not held for collection or settlement over the period to contractual maturity:

At 31 December 2011	Less than twelve months	Equal to or more than twelve months	Total
	$millions	$millions	$millions
ASSETS			
Loans and receivables:			
Cash at bank	11,180	-	11,180
Securities borrowed	29,575	-	29,575
Reverse repurchase agreements	95,909	1,309	97,218
Trade receivables	67,371	-	67,371
Other receivables	7,065	160	7,225
	211,100	1,469	212,569
Financial assets classified as held for trading	354,140	3	354,143
Financial assets designated at fair value through profit or loss	2,144	6,418	8,562
Available-for-sale financial assets	-	67	67
Current tax	145	-	145
Deferred tax assets	-	44	44
Prepayments and accrued income	45	-	45
Property, plant and equipment	-	10	10
Joint Venture	-	-	-
	567,574	8,011	575,585
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	124	-	124
Securities loaned	25,516	500	26,016
Repurchase agreements	73,290	3,614	76,904
Trade payables	83,626	-	83,626
Other payables	20,654	1,053	21,707
Subordinated loans	-	7,906	7,906
Preference shares	-	-	-
	203,210	13,073	216,283
Financial liabilities classified as held for trading	333,825	-	333,825
Financial liabilities designated at fair value through profit or loss	8,835	2,875	11,710
Provisions	6	4	10
Current tax	68	-	68
Deferred tax liabilities	-	7	7
Accruals and deferred income	200	-	200
Retirement benefit obligations	-	4	4
	546,144	15,963	562,107

24. EXPECTED MATURITY OF FINANCIAL ASSETS AND LIABILITIES (CONTINUED)

At 31 December 2010	Less than twelve months	Equal to or more than twelve months	Total
	$millions	$millions	$millions
ASSETS			
Loans and receivables:			
Cash at bank	10,436	-	10,436
Securities borrowed	27,852	-	27,852
Reverse repurchase agreements	112,183	-	112,183
Trade receivables	64,027	-	64,027
Other receivables	13,374	193	13,567
	227,872	193	228,065
Financial assets classified as held for trading	270,994	-	270,994
Financial assets designated at fair value through profit or loss	2,419	6,940	9,359
Available-for-sale financial assets	-	44	44
Current tax	377	-	377
Deferred tax assets	-	48	48
Prepayments and accrued income	29	-	29
Property, plant and equipment	-	12	12
Joint Venture	-	7	7
	501,691	7,244	508,935
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	60	-	60
Securities loaned	52,752	307	53,059
Repurchase agreements	100,636	1,892	102,528
Trade payables	75,639	-	75,639
Other payables	24,557	-	24,557
Subordinated loans	-	7,906	7,906
Preference shares	-	786	786
	253,644	10,891	264,535
Financial liabilities classified as held for trading	220,793	-	220,793
Financial liabilities designated at fair value through profit or loss	9,578	4,135	13,713
Provisions	26	3	29
Current tax	434	-	434
Deferred tax liabilities	-	5	5
Accruals and deferred income	291	-	291
Retirement benefit obligations	-	4	4
	484,766	15,038	499,804

25. 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.

25. SEGMENT REPORTING (CONTINUED)

Business segments (continued)

2011 Consolidated income statement information	Institutional Securities $millions	Other $millions	Total $millions
Net gains on financial instruments classified as held for trading	3,455	84	3,539
Net gains on financial instruments designated at fair value through profit or loss	275	-	275
Net gain on disposal of joint venture	21	-	21
Net gain on disposal of subsidiaries	5	-	5
Net interest	30	(17)	13
Other income	257	8	265
External revenues net of interest expense	4,043	75	4,118
Other expense	(3,224)	(69)	(3,293)
Profit before tax	819	6	825
Income tax expense	(251)	(1)	(252)
Profit for the year	568	5	573
Consolidated statement of financial position information			
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

25. SEGMENT REPORTING (CONTINUED)

Business segments (continued)

2010 **Consolidated income statement information**	Institutional Securities $millions	Other $millions	Total $millions
Net gains on financial instruments classified as held for trading	3,620	32	3,652
Net gains on financial instruments designated at fair value through profit or loss	318	-	318
Net gains on available-for-sale financial assets	59	-	59
Net gain on disposal of subsidiary	-	-	-
Net interest	(121)	20	(101)
Other income	179	9	188
External revenues net of interest expense	4,055	61	4,116
Other expense	(3,253)	(100)	(3,353)
Profit / (loss) before tax	802	(39)	763
Income tax (expense) / credit	(545)	29	(516)
Profit / (loss) for the year	257	(10)	247
Consolidated statement of financial position information			
Segment assets	503,600	5,328	508,928
Joint venture	7	-	7
Total assets	503,607	5,328	508,935
Segment liabilities	496,503	3,301	499,804
Total Liabilities	496,503	3,301	499,804
Other Segment Information			
Property, plant and equipment capital expenditure	1	-	1
Depreciation on property, plant and equipment	5	-	5

25. SEGMENT REPORTING (CONTINUED)

Geographical segments

The Group operates in three geographic regions as listed below:

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

The following table presents selected consolidated income statement and consolidated statement of financial position information of the Group's operations by geographic area. The external revenues (net of interest expense) and total assets disclosed in the following table reflect the regional view of the Group's operations, on a managed basis. The basis for attributing external revenues (net of interest expense) and total assets is determined by a combination of client and trading desk location.

	EMEA		Americas		Asia		Total	
	2011 $millions	2010 $millions	2011 $millions	2010 $millions	2011 $millions	2010 $millions	2011 $millions	2010 $millions
External revenues net of interest	4,006	3,991	97	98	15	27	4,118	4,116
Profit before income tax	747	675	68	77	10	11	825	763
Total assets	442,096	401,829	93,754	58,653	39,735	48,453	575,585	508,935

26. 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 Directors' report, the Group has exposure to European peripheral countries, which are defined as Portugal, Ireland, Italy, Greece and Spain. The Group's exposure is included within either the credit risk or the market risk disclosures below consistent with how the financial instrument is managed. Significant risks faced by the Group resulting from its trading, financing and investment activities are set out below.

Credit risk

Credit risk refers to the risk of loss arising from a borrower or counterparty default.

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

The Group 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 31 December 2011, 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.

The Group also reviews its credit exposure and risk to types of customers. At 31 December 2011, 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.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Reverse repurchase agreements and securities borrowed

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

Derivatives

The Group may seek to mitigate credit risk from its derivatives transactions in multiple ways. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size and maturity. The Group actively hedges its 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 31 December 2011 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. Where the Group enters into credit enhancements, such as cash and security as collateral and master netting agreements, to manage the credit exposure on these financial instruments the financial effect of the credit enhancements is also disclosed below. The credit exposure remaining after the effect of the credit enhancements is disclosed as the net credit exposure. 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 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.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class

Class	2011			2010		
	Gross credit exposure [1] $millions	Credit enhancements $millions	Net credit exposure [2] $millions	Gross credit exposure $millions	Credit enhancements $millions	Net credit exposure [2] $millions
Loans and receivables:						
Cash at bank	11,180	-	11,180	10,436	-	10,436
Cash collateral on securities borrowed	29,575	(28,604)	971	27,852	(26,211)	1,641
Reverse repurchase agreements	97,218	(96,576)	642	112,183	(106,426)	5,757
Trade receivables [3]	44,113	-	44,113	39,632	-	39,632
Other receivables	7,096	-	7,096	13,437	-	13,437
Financial assets classified as held for trading:						
OTC Derivatives	291,005	(268,962)	22,043	171,386	(148,655)	22,731
Financial assets designated at fair value through profit or loss	8,562	(7,410)	1,152	9,359	(9,178)	181
	488,749	(401,552)	87,197	384,285	(290,470)	93,815
Unrecognised financial instruments						
Contingent commitments	3,010	-	3,010	1,194	-	1,194
Financial guarantees	1	-	1	-	-	-
Lease commitments	-	-	-	26	-	26
Loan commitments	986	-	986	682	-	682
Underwriting commitments	156	-	156	128	-	128
Unsettled reverse repurchase agreements [4]	22,448	-	22,448	29,784	-	29,784
	515,350	(401,552)	113,798	416,099	(290,470)	125,629

(1) The carrying amount recognised in the consolidated statement of financial position best represents the Group's maximum exposure to credit risk.

(2) Of the residual net credit exposure, intercompany cross-product netting arrangements are in place which would allow for an additional $4,032 million (2010: $3,893 million) to be offset in the event of default by certain Morgan Stanley counterparties.

(3) Trade receivables primarily include cash collateral pledged against the payable on OTC derivative positions. These derivative liabilities are included within financial liabilities classified as held for trading in the consolidated statement of financial position.

(4) For unsettled reverse repurchase agreements, collateral in the form of securities will be received at the point of settlement. Since the value of collateral is determined at a future date it is currently unquantifiable and not included in the table.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Maximum exposure to credit risk by credit rating [1]

Credit rating	**Gross credit exposure 2011 $millions**	**Gross credit exposure 2010 $millions**
AAA	22,157	34,944
AA	79,850	99,461
A	338,888	230,416
BBB	49,771	22,707
BB	7,086	7,402
B	9,924	5,932
CCC	3,592	7,984
Unrated	4,082	7,253
Total	515,350	416,099

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

At 31 December 2011 there were no financial assets individually impaired (2010: None).

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk

Liquidity risk is the risk that the entity may encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

The Morgan Stanley Group's senior management establishes the overall liquidity and funding policies of the Morgan Stanley Group and the liquidity risk management policies and procedures conducted within the Group are consistent with those of the Morgan Stanley Group. The Morgan Stanley Group's liquidity and funding risk management policies are designed to mitigate the potential risk that entities within the Morgan Stanley Group, including 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 Reserves. 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 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.

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.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

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, 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 31 December 2011. Repayments of financial liabilities that are subject to immediate notice are treated as if notice were given immediately and are classified as on demand. This presentation is considered by the Group to appropriately reflect the liquidity risk arising from those financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial liabilities is managed by the Group.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Maturity analysis

	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
Preference shares	-	-	-	-	-	-	-
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
Lease commitments	9	-	-	-	13	-	22
Financial guarantees	1	-	-	-	-	-	1
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 contingent commitments and loan commitments will be required.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Maturity analysis

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

* Preference shares are assumed to be redeemed in 20 years

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

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as liquidity, will result in losses for a position or portfolio.

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

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

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

Risk and capital management initiative

The Group frequently enhances its market and credit risk management framework to address severe stresses that are observed in global markets during economic downturns. During 2011, the Group expanded and improved its risk measurement processes, including stress tests and scenario analysis, and further refined its market and credit risk limit framework. Stress Value-at-Risk ("S-VaR"), a proprietary methodology that comprehensively measures the Group's market and credit risks, was further refined and continues to be an important metric used in establishing the Group's risk appetite and its capital allocation framework. S-VaR simulates many stress scenarios based on more than 25 years of historical data and attempts to capture the different liquidities of various types of general and specific risks. Additionally, S-VaR captures event and default risks that are particularly relevant for credit portfolios.

Primary market risk exposures and market risk management

During the year ended 31 December 2011, the Group had exposures to a wide range of interest rates, equity prices, foreign exchange rates and commodity prices - and the associated implied volatilities and spreads - related to the global markets in which it conducts its trading activities.

The Group is exposed to interest rate and credit spread risk as a result of its market-making activities and other trading in interest rate-sensitive financial instruments (e.g., risk arising from changes in the level or implied volatility of interest rates, the 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.

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.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

The Group, as part of the Morgan Stanley Group's global market risk management framework manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (e.g., futures, forwards, swaps and options). Hedging activities may not always provide effective mitigation against trading losses due to differences in the terms, specific characteristics or other basis risks that may exist between the hedge instrument and the risk exposure that 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).

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.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

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.

VaR for the year ended 31 December 2011

The table below presents VaR for the Group's Trading portfolio, on a year-end, annual average and annual high and low basis (see table below) for 31 December 2011 and 31 December 2010.

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.

95% VaR

	95% / one-day VaR 2011				95% / one-day VaR 2010			
Market Risk Category	**Period End $'m**	**Average $'m**	**High $'m**	**Low $'m**	**Period End $'m**	**Average $'m**	**High $'m**	**Low $'m**
Interest rate and credit spread	27	36	52	24	44	52	71	37
Equity price	16	21	33	13	25	21	52	12
Foreign exchange rate	6	6	15	2	8	9	18	3
Commodity price	3	5	12	2	2	3	9	2
Less: Diversification benefit	(25)	(25)	N/A	N/A	(23)	(25)	N/A	N/A
Primary Risk Categories VaR	27	43	67	27	56	60	87	45
Credit Portfolio VaR	18	21	26	16	19	17	26	11
Less: Diversification benefit	(10)	(10)	N/A	N/A	(6)	(10)	N/A	N/A
Total trading VaR	35	54	78	35	69	67	98	41

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

(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.

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

The Group's average VaR for the Primary Risk Categories for 2011 was $43 million compared with $60 million for 2010. Reduced risk taking in fixed income products was the primary driver of the decrease. The reduction in period-end VaR from $56 million for 2010 to $27 million for 2011 more clearly demonstrates the reduced risk taking in fixed income products that occurred at the end of the third quarter of 2011 that continued through the fourth quarter of 2011.

The average Credit Portfolio VaR for 2011 was $21 million compared with $17 million for 2010. The increase in the average VaR over the year was from increased counterparty exposure during 2011, although this had decreased at year-end.

The average Total Trading VaR for 2011 was $54 million compared with $67 million for 2010.

Non-trading risks for the year ended 31 December 2011

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 $3.8 million as at 31 December 2011, compared to a net gain or loss of $2.5 million as at 31 December 2010.

Counterparty Exposure Related to the Group's Own Spread

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 and $3 million for each 1 basis point widening in the Group's credit spread level for 31 December 2011 and 31 December 2010, respectively.

Structured Notes

The credit spread risk sensitivity of the Group's mark-to-market structured notes corresponded to an increase in value of approximately $0.4 million for each 1 basis point widening in the Group's credit spread level at both 31 December 2011 and 31 December 2010.

Available-for-sale Financial Assets

The Group makes investments in both public and private companies. 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.

	2011 **10% sensitivity** **$millions**
Private equity and infrastructure funds	6.7
	6.7

26. 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.

	2011			2010		
Foreign currency exposure		**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	(6)	27%	2	(6)	27%	2
Euro	405	7%	28	366	7%	25
British Pound	51	29%	15	44	29%	13
New Taiwan Dollar	66	8%	5	60	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Singapore Dollar	-	9%	-	4	9%	-
South Korean Won	168	42%	71	183	42%	77
Swedish Krona	15	23%	3	15	23%	3
Swiss Franc	7	10%	1	5	10%	-
	708			673		

The reasonably possible percentage change in the currency rate against US dollars has been calculated based on the greatest annual percentage change over a four-year period from 1 December 2007 to 31 December 2011. Thus the percentage change applied may not be the same percentage change in the currency rate for the year.

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.

27. TRANSFERS OF FINANCIAL ASSETS, INCLUDING PLEDGES OF COLLATERAL

In the ordinary course of business, the Group enters into various transactions that result in the transfer of financial assets to third parties, which for accounting purposes may not give rise to full derecognition of the financial asset.

The following table presents those financial assets which have been sold or otherwise transferred, but which for accounting purposes do not qualify for derecognition and continue to be recognised in the consolidated statement of financial position.

	2011 $millions	2010 $millions
Government debt securities	6,765	13,777
Corporate equities	17,722	38,711
Corporate and other debt	17,454	13,062
	41,941	65,550

The majority of financial assets that do not qualify for derecognition arise from repurchase agreements and securities lending arrangements. Under these types of transactions, the Group generally retains substantially all risks and rewards of the transferred assets including credit risk, settlement risk, country risk and market risk.

Other financial assets transferred that continue to be recognised for accounting purposes include pledges of securities as collateral for open derivative transactions, as well as certain sales of securities with related transactions, such as derivatives, that result in the Group either retaining substantially all the risks and rewards of the financial assets transferred, or not retaining substantially all the risks and rewards but retaining control of those financial assets.

These transactions are mostly conducted under standard agreements used by financial market participants and are undertaken with counterparties subject to the Group's normal credit risk control processes. The resulting credit exposures are controlled by daily monitoring and collateralisation of the positions. The carrying amount of the associated liabilities related to financial assets transferred that continue to be recognised approximate the carrying amount of those transferred assets.

28. FINANCIAL ASSETS ACCEPTED AS COLLATERAL

The Group accepts financial assets as collateral which, dependent on the terms of the arrangement, the Group is allowed to sell or repledge. The majority of the financial assets accepted as collateral are received as part of reverse repurchase agreements or securities borrowing arrangements and are mostly conducted under standard documentation used by financial market participants.

The fair value of collateral accepted under such arrangements as at 31 December 2011 was $179,493 million (2010: $202,562 million). Of this amount $147,681 million (2010: $171,194 million) has been sold or repledged to third parties in connection with financing activities, or to comply with commitments under short sale transactions.

29. 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 31 December 2011 the total assets of SPEs in which the Group has an interest, but which are not consolidated by the Group, are $212 million (2010: $135 million) and the Group's maximum exposure to loss relating to such SPEs is $174 million (2010: $59 million). The Group's consolidated balance sheet includes $2,904 million of assets arising from consolidated SPEs (2010: $4,252 million). The Group's maximum exposure to loss relating to these assets is $1,279 million (2010: $2,036 million).

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Fair value hierarchy

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

- *Quoted prices (unadjusted) in an active market for identical assets or liabilities (Level 1)* - valuations based on quoted prices in active markets for identical assets or liabilities that the Morgan Stanley Group has the ability to access. Valuation adjustments and block discounts are not applied to Level 1 instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuations of these products does 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.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and liabilities recognised at fair value

The following tables 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:

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

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Financial assets and liabilities recognised at fair value (continued)

2010	Quoted prices in active market (Level 1) $millions	Valuation techniques using observable inputs (Level 2) $millions	Valuation techniques with significant non-observable inputs (Level 3) $millions	Total $millions
Financial assets classified as held for trading:				
- Government debt securities	12,369	4,002	-	16,371
- Corporate equities	44,908	1,134	146	46,188
- Corporate and other debt	110	18,627	3,359	22,096
- Derivatives	968	183,006	2,365	186,339
Total financial assets classified as held for trading	58,355	206,769	5,870	270,994
Financial assets designated at fair value through profit or loss	-	8,830	529	9,359
Available-for-sale financial assets:				
- Corporate equities	4	-	40	44
Total financial assets measured at fair value	58,359	215,599	6,439	280,397
Financial liabilities classified as held for trading:				
- Government debt securities	11,944	3,161	-	15,105
- Corporate equities	13,571	447	11	14,029
- Corporate and other debt	-	4,695	26	4,721
- Derivatives	924	182,150	3,864	186,938
Total financial liabilities classified as held for trading	26,439	190,453	3,901	220,793
Total financial liabilities designated at fair value through profit and loss	-	12,858	855	13,713
Total financial liabilities measured at fair value	26,439	203,311	4,756	234,506

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

Corporate equities

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

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.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

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

Corporate and other debt (continued)

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

Derivatives

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

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

Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be either observed or modelled using a series of techniques, and model inputs from comparable benchmarks, including closed-form 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.

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.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

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

Derivatives (continued)

OTC Derivative Contracts (continued)

Derivative interests in complex mortgage-related CDOs and ABS credit default swaps, 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.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy (continued)

Corporate loans

Corporate loans and lending commitments. The fair value of corporate loans is estimated using recently executed transactions, market prices 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 tables presents the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the year ended 31 December 2011. 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.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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)
	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions	$millions
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 year, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the year.

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2011 related to assets and liabilities still outstanding at 31 December 2011. The unrealised gains or (losses) are recognised in the consolidated income statement or statement of total recognised gains and losses as detailed in the financial instruments accounting policy (note 3c)

(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.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

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

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2010 related to assets and liabilities still outstanding at 31 December 2010. The unrealised gains or (losses) are recognised in the consolidated income statement or statement of total recognised gains and losses as detailed in the financial instruments accounting policy (note 3c)

(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. All cash flows on derivative contracts are presented in settlements.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

As disclosed in note 35 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 table are risk managed using financial instruments held by other Morgan Stanley Group undertakings, these policies potentially result in the recognition of offsetting gains or losses in the Group.

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

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

During the year, the Group reclassified approximately $1,027 million of Government Debt security assets and approximately $1,778 million of Government Debt security liabilities from Level 1 to Level 2. These reclassifications primarily related to certain European peripheral government bonds as these securities traded with a high degree of pricing volatility, dispersion and wider bid-ask spreads. The Group continues to mark these securities to observable market price quotations.

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.

30. 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:

2011		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	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.

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

2010		Effect of reasonably possible alternative assumptions	
	Fair Value $millions	Increase in fair value $millions	Decrease in fair value $millions
Financial assets classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	146	3	(3)
- Corporate and other debt	3,359	211	(210)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	-	-	-
- Structured notes	-	-	-
- Other	529	11	(6)
Available-for-sale financial assets:			
- Corporate equities	40	1	(1)
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	(11)	-	(1)
- Corporate and other debt	(26)	1	(1)
- Net derivatives contracts (1)	(1,499)	126	(147)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	(3)	-	-
- Structured notes	-	-	-
- Other	(852)	8	(8)

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

30. 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:

	2011 $millions	2010 $millions
At 1 January	260	215
New transactions	307	94
Amounts recognised in the consolidated income statement during the year	(31)	(49)
At 31 December	536	260

The balance above predominantly relates to derivatives.

The 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.

31. FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE

For all financial assets and financial liabilities not recognised at fair value, the carrying amount is considered to be a reasonable approximation of fair value due to the short term nature of these financial assets and liabilities, except for the following:

31 December 2011	Carrying value $millions	Fair value $millions	Unrecognised gain / (loss) $millions
Financial liabilities			
Subordinated loans	7,906	5,769	2,137

As at 31 December 2011 Securities purchased under agreements to resell and cash collateral on stocks borrowed and Securities sold under agreements to repurchase and cash collateral on stocks loaned carrying value was considered to be a reasonable approximation of fair value.

31 December 2010	Carrying value $millions	Fair value $millions	Unrecognised gain / (loss) $millions
Financial assets			
Securities purchased under agreements to resell and cash collateral on stocks borrowed	71,990	72,016	26
Financial liabilities			
Subordinated loans	7,906	6,088	1,818
Preference shares	786	588	198
Securities sold under agreements to repurchase and cash collateral on stocks loaned	72,147	72,151	(4)

The fair value for subordinated loans has been determined based on the assumption that all subordinated loans are held to the latest repayment date, although the amounts outstanding are repayable at any time at the Group's option, subject to seven business days' notice to the FSA, which has the right to refuse consent to repayment.

32. CAPITAL MANAGEMENT

The Morgan Stanley Group manages its capital on a global basis with consideration for its legal entities. The capital managed by the Morgan Stanley Group broadly includes ordinary share capital, preference share capital, subordinated loans and reserves.

The Morgan Stanley Group's capital estimate is based on the Required Capital Framework, an internal capital adequacy measure. The framework is a risk-based internal use of capital measure, which is compared with the Morgan Stanley Group's regulatory capital to help ensure the Morgan Stanley Group maintain an amount of risk-based going concern capital after absorbing potential losses from extreme stress events at a point in time. The difference between the Morgan Stanley Group's regulatory capital and aggregate Required Capital is the Morgan Stanley Group's Parent capital.

Tier 1 capital and common equity attribution to the business segments is based on capital usage calculated by required Capital. In principle, each business segment is capitalised as if it were an operating entity with limited diversification benefit between the business segments. Required Capital is assessed at each business segment and further attributed to product lines. The process is intended to align capital with the risks in each business segment in order to allow senior management to evaluate returns on a risk-adjusted basis.

The Required Capital Framework will evolve over time in response to changes in the business and regulatory environment and to incorporate enhancements in modelling techniques.

The Morgan Stanley Group actively manages its consolidated capital position based upon, among other things, business opportunities, risks, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and, therefore, in the future may expand or contract its capital base to address the changing needs of its businesses.

The Morgan Stanley Group also aims to adequately capitalise at a legal entity level whilst safeguarding that entity's ability to continue as a going concern and ensuring that it meets all regulatory capital requirements, so that it can continue to provide returns for the Morgan Stanley Group.

The Group is regulated by the Financial Services Authority ("FSA") and as such is subject to minimum capital requirements. The Group's capital is monitored on an ongoing basis to ensure compliance with the rules within the FSA's General Prudential Sourcebook. At a minimum, the Group must ensure that Capital Resources (share capital, subordinated debt, audited profit and loss and eligible reserves) are greater than the Capital Resource Requirement covering credit, market and operational risk. The Group complied with all of its regulatory capital requirements during the year.

In December 2010, the Basel Committee on Banking Supervision published the final rules text on a comprehensive set of reform measures, developed to strengthen the regulation, supervision and risk management of the banking sector ("the Basel III Framework"). In July 2011, the European Commission published draft legislation to implement these measures in Europe with an expected effective date of 1 January 2013.

The Basel III Framework covers both microprudential and macroprudential elements. It sets out requirements for higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. The Morgan Stanley Group is currently working to ensure compliance with these new regulatory standards as they are implemented from 2013 onwards.

In addition to the Basel III Framework, new standards relating to market risk capital requirements were implemented with effect from 31 December 2011.

As a result of the new capital requirements, the Group continues to actively review and manage its capital position. As part of this capital management, the Group has issued $5,386 million of ordinary share capital, repurchased $2,286 million of its equity and debt preference shares and paid dividends of $128 million in 2011.

32. CAPITAL MANAGEMENT (CONTINUED)

The Group considers the below to be its managed capital:

	2011 $millions	2010 $millions
Ordinary share capital	8,414	3,028
Preference share capital	1,050	2,550
Subordinated loans	7,906	7,906
Preference shares classified as debt instruments	-	786
Reserves	3,943	3,480
	21,313	17,750

33. EMPLOYEE COMPENSATION PLANS

As described in note 35, the Group utilises staff employed by other Morgan Stanley Group undertakings and incurs management charges in respect of these employee services. These management charges include the costs of equity-based compensation provided to these employees.

Equity settled share based compensation plans

Deferred stock awards

Morgan Stanley has made deferred stock awards pursuant to several equity-based compensation plans. The plans provide for the deferral of a portion of certain key employees' discretionary compensation with awards made in the form of a right to receive unrestricted shares of common stock in the future ("restricted stock units"). Awards under these plans are generally subject to vesting over time contingent upon continued employment and to restrictions on sale, transfer or assignment until the end of a specified period, generally two to three years from date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant restriction period. All or a portion of a vested award also may be cancelled in certain limited situations, including termination for cause during the relevant restriction period. Recipients of deferred stock awards generally have voting rights and receive dividend equivalents.

During the year, Morgan Stanley granted 385,877 units of restricted stock units to employees of the Group with a weighted average fair value per unit of $29.20 (2010: 464,505 units, weighted average fair value $29.24 per unit) based on the market value of Morgan Stanley shares at grant date.

Stock option awards

Morgan Stanley has also granted stock option awards in the form of stock options on Morgan Stanley's common stock. The stock options generally have an exercise price of not less than the fair value of Morgan Stanley's common stock on the date of grant and generally become exercisable over a three year period, expiring ten years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are similar to those in deferred stock awards.

There were no options granted during the year (2010: none).

33. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Stock option awards (continued)

The following table shows activity relating to the Morgan Stanley Group's stock option awards for employees of the Group:

	2011		2010	
	Number of options '000s	Weighted average exercise price $	Number of options '000s	Weighted average exercise price $
Options outstanding at 1 January	263	51.74	325	53.47
Expired during the year	(22)	59.82	(62)	60.79
Options outstanding at 31 December	241	50.99	263	51.74
Options exercisable at 31 December	241	50.99	263	51.74

The following table presents information relating to the stock options outstanding:

	2011			2010		
Range of exercise prices	Number of options '000s	Weighted average exercise price $	Average remaining life in years	Number of options '000s	Weighted average exercise price $	Average remaining life in years
\$30.00 - \$39.99	59	36.25	1.0	59	36.25	2.0
\$40.00 - \$49.99	103	47.42	1.4	104	47.42	2.4
\$50.00 - \$59.99	-	-	-	10	55.61	0.1
\$60.00 - \$69.99	79	66.73	5.0	90	66.31	5.5
Total	241	50.99	2.5	263	51.74	3.3

Other deferred compensation plans

The Group has granted non-equity based deferred compensation awards to certain of its key employees. The plans provide for the deferral of a portion of the employees' discretionary compensation with awards that provide a return based upon the performance of various referenced investments. Awards under these plans are generally subject to a sole vesting condition of service over time, which normally ranges from six months to three years from the date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant vesting period. The awards are settled in cash at the end of the relevant vesting period.

Awards with a value of $11 million (2010: $7 million) have been granted to employees during the year and an expense of $26 million (2010: $5 million) has been recognised within 'Staff costs' in 'Other expense' in the consolidated income statement in relation to awards outstanding. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the consolidated statement of financial position, is $30 million (2010: $22 million).

The Group economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation schemes is $3 million (2010: $3 million) and the related profit and loss recorded within 'Net gains / losses on financial instruments classified as held for trading' for the year is $nil (2010: $1 million gain).

34. RETIREMENT BENEFITS

Defined contribution plans

The Group operates several Morgan Stanley defined contribution plans which require contributions made to the plans to be held in trust, separate from the assets of the Group.

The defined contribution plans are as follows:

Morgan Stanley Flexible Company Pension Plan (Amsterdam)

Morgan Stanley & Co. International plc, (Greece Branch) Group Insurance Policy

MSII Offshore Retirement Benefit Plan IV, Dubai Section

Morgan Stanley Asia Limited Retirement Benefit Plan

The defined contribution pension charge recognised within 'Staff costs' in 'Other expense' in the consolidated income statement was $3 million for the year (2010: $1 million) of which $nil was accrued at 31 December 2011 (2010: $nil).

Defined benefit plans

The Group also operates several Morgan Stanley defined benefit plans, which provide pension benefits that are based on an actuarial valuation. The Group's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations.

The defined benefits plans are as follows:

Morgan Stanley & Co International plc Paris Branch IFC (Indemnites de Fin de Carriere) ("Paris Branch Plan")

Morgan Stanley France (SAS) Leaving Indemnity Plan (Indemnites de Fin de Carriere) ("MS France Plan")

Morgan Stanley & Co International plc (Athens Branch) Retirement Indemnity ("Athens Branch Plan")

Morgan Stanley Asia (Taiwan) Limited Retirement Scheme ("Taiwan Retirement Plan")

Morgan Stanley Asia (Taiwan) Limited Book Reserve Plan ("Taiwan Reserve Plan")

Personalvorsorgestiftung der Bank Morgan Stanley AG Plan ("Zurich Branch Plan")

Morgan Stanley Dubai End of Service Gratuity ("Dubai Branch Plan")

During 2010, Bank Morgan Stanley AG transferred its institutional securities business to the Zurich Branch but its employees remained in the same Personalvorsorgestiftung der Bank Morgan Stanley AG Plan, together with all remaining Bank Morgan Stanley AG employees. The plan was considered as transferred into the Zurich Branch with the difference between assets and liabilities at initial recognition included in other comprehensive income.

Defined benefit plan expense

The amounts recognised in 'Staff costs', within 'Other expense', in the consolidated income statement in respect of these defined benefit plans are as follows:

	2011 $millions	2010 $millions
Current service cost	2	3
Past service cost	(1)	-
Interest on obligation	1	1
Defined benefit plan expense	2	4

Actuarial gains and losses have been reported in other comprehensive income.

The actuarial gains and losses recognised in the other comprehensive income is $2 million gain (2010: $3 million loss).

34. RETIREMENT BENEFITS (CONTINUED)

Retirement benefit obligation

The following table provides a reconciliation of the present value of the defined benefit obligation and fair value of plan assets included in the consolidated statement of financial position, as well as a summary of the funded status of the plans.

	2011 $millions	2010 $millions
Retirement benefit liability:		
Present value of funded defined benefit obligation	(19)	(13)
Fair value of plan assets	17	11
	(2)	(2)
Present value of unfunded defined benefit obligation	(2)	(2)
Retirement benefit liability recognised in the consolidated statement of financial position	(4)	(4)

Contributions for the year to the defined benefit plan totalled $2 million (2010: $6 million), of which $nil was accrued at 31 December 2011 (2010: $nil). The Group expects to contribute $1 million (2010: $2 million) in the next financial year, based upon the current funded status, and the expected return assumptions for the next financial year.

Changes in the present value of the defined benefit obligation during the year were as follows:

	2011 $millions	2010 $millions
Reconciliation of defined benefit obligations:		
Defined benefit obligations at 1 January	15	7
Current service cost	2	3
Past service cost	(1)	-
Interest cost	1	1
Actuarial loss	1	1
Transfer in	3	11
Benefits paid	(1)	(1)
Liabilities extinguished on settlements	-	(7)
Plan participants' contributions	1	-
Defined benefit obligations at 31 December	21	15

Changes in the fair value of plan assets were as follows:

	2011 $millions	2010 $millions
Reconciliation of fair value of plan assets:		
Fair value of plan assets at 1 January	11	3
Transfer in	3	9
Assets distributed on settlements	-	(7)
Employer contributions	2	6
Benefits paid	(1)	(1)
Plan participants' contributions	1	-
Foreign exchange rate changes	1	-
Expected return on plan assets	-	1
Fair value of plan assets at end of the year	17	11
Actual return / (deficit) on fund assets	-	-

34. RETIREMENT BENEFITS (CONTINUED)

Retirement benefit obligation (continued)

The major categories of the total plan assets are as follows:

	Fair value of assets 2011 $millions	2010 $millions
Equity securities	4	3
Fixed income securities	7	4
Property	1	-
Cash	5	4
	17	11

The expected long-term rate of return on assets represents the Group's best estimate of the long-term return on the plan assets and generally was estimated by computing a weighted average return of the underlying long-term expected returns on the different asset classes, based on the target asset allocations. For plans where there is no established target asset allocation, actual asset allocations were used. The expected long-term return on assets is a long-term assumption that generally is expected to remain the same from one year to the next unless there is a significant change in the target asset allocation, the fees and expenses paid by the plan or market conditions.

The Group, in consultation with its independent investment consultants and actuaries, determined the asset allocation targets based on its assessment of business and financial conditions, demographic and actuarial data, funding characteristics and related risk factors. Other relevant factors, including industry practices, long-term historical and prospective capital market returns, were also considered.

The Plan return objectives provide long-term measures for monitoring the investment performance against growth in the pension obligations. The overall allocation is expected to help protect the plan's funded status while generating sufficiently stable real returns (net of inflation) to help cover current and future benefit payments.

Both the equity and fixed income portions of the asset allocation use a combination of active and passive investment strategies and different investment styles. The fixed income asset allocation consists of longer duration fixed income securities in order to help reduce plan exposure to interest rate variation and to better correlate assets with obligations. The longer duration fixed income allocation is expected to help stabilise plan contributions over the long run.

The following table presents the principal actuarial assumptions at the end of the reporting period:

	2011	2010
Discount rate	1.75% - 4.75%	2.00% - 7.05%
Rate of increase in salaries	2.25% - 4.00%	2.50% - 5.50%
Inflation assumption	1.50% - 2.00%	1.50% - 2.00%
Expected long-term rate of return on plan assets:		
- At 1 January	2.50% - 4.60%	2.25% - 3.50%
- At 31 December	2.25% - 4.10%	2.50% - 4.60%

34. RETIREMENT BENEFITS (CONTINUED)

Retirement benefit obligation (continued)

The mortality assumptions used give the following life expectations at 65:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
31 December 2011					
Switzerland	Swiss BVG 2010, Static Mortality Table	84.7	84.7	87.0	87.0
31 December 2010					
Switzerland	Unadjusted BVG 2005, Mortality Table	82.9	82.9	86.0	86.0

The sensitivities regarding the principal assumptions used to measure the defined benefit obligation are as follows:

Assumption	Change in assumption	Impact on scheme liabilities
Paris Branch Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 3.27% / increase by 3.38%
MS France Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 1.11% / increase by 1.12%
Taiwan Retirement Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 4.61% / increase by 5.03%
Taiwan Reserve Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 5.72% / increase by 6.25%
Zurich Branch Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 5.30% / increase by 6.00%
Inflation assumption	Increase by 0.5% / decrease by 0.5%	Increase by 1.40% / decrease by 1.10%
Rate of increase in salaries	Increase by 0.5% / decrease by 0.5%	Increase by 0.20% / decrease by 0.40%
Rate of mortality	Increase by 1 year	Increase by 0.40%
Dubai Branch Plan		
Discount rate	Increase by 0.25% / decrease by 0.25%	Decrease by 2.56% / increase by 2.68%
Rate of increase in salaries	Increase by 0.25% / decrease by 0.25%	Increase by 2.68% / decrease by 2.58%

34. RETIREMENT BENEFITS (CONTINUED)

Retirement benefit obligation (continued)

The five-year history of experience adjustments is as follows:

	2011 $millions	2010 $millions	2009 $millions	2008 $millions	2007 $millions
Present value of defined benefit obligation	(21)	(15)	(7)	(5)	(8)
Fair value of plan assets	17	11	3	3	4
Deficit	(4)	(4)	(4)	(2)	(4)
Experience adjustments on plan liabilities:					
Amount	-	1	(1)	(1)	-
Percentage of plan liabilities (%)	1.41%	4.38%	(12.48%)	(15.85%)	0.31%
Experience adjustments on plan assets:					
Amount	-	-	-	-	-
Percentage of plan liabilities (%)	(2.94%)	(1.30%)	2.22%	(3.79%)	0.77%

Plans operated by fellow Morgan Stanley undertakings

Along with a number of other Morgan Stanley Group companies, the Group incurs management charges from a fellow Morgan Stanley undertaking, Morgan Stanley UK Limited ("MSUK"), in respect of MSUK's employees' services. These management recharges include pension costs related to the Morgan Stanley UK Group Pensions Plan (the "UK Plan"). The UK Plan is a defined contribution scheme with a closed defined benefit section. There is no contractual arrangement for recharging the costs of the UK Plan as a whole measured in accordance with IAS 19. Accordingly, the Group recognised its contribution payable for the period as an expense. On this basis, the management recharge for the year in respect of the defined benefit plan recognised in the consolidated income statement was $10 million (2010: $9 million).

For the purposes of IAS 19 disclosure, information about the defined benefit section of the UK Plan as a whole, is presented below.

Defined benefit plan expense

The amounts that would be recognised in 'Staff costs', within 'Other expense', in the consolidated income statement in respect of these defined benefit plans are as follows:

	2011 $millions	2010 $millions
Expected return on fund assets	(8)	(6)
Interest on obligation	8	8
Foreign exchange rate changes	1	-
Defined benefit plan expense	1	2

34. RETIREMENT BENEFITS (CONTINUED)

Retirement benefit obligation (continued)

Plans operated by fellow Morgan Stanley undertakings (continued)

Defined benefit asset / liability

The following table provides a reconciliation of the present value of the defined benefit obligation and fair value of plan assets that would be included in the consolidated statement of financial position, as well as a summary of the funded status of the plans:

	2011 $millions	2010 $millions
Retirement benefit liability:		
Present value of funded defined benefit obligation	(183)	(145)
Fair value of plan assets	229	167
	46	22
Adjustment for ceiling	(46)	(22)
Retirement benefit liability recognised in the consolidated statement of financial position	-	-

Contributions for the year to the defined benefit plan by Morgan Stanley UK totalled $10 million (2010: $9 million), of which $nil was accrued at 31 December 2011 (2010: $nil). Morgan Stanley UK expects to contribute $10 million (2010: $9 million) in the next financial year, based upon the current funded status and the expected return assumptions for the next financial year.

Changes in the present value of the defined benefit obligation during the year were as follows:

	2011 $millions	2010 $millions
Reconciliation of defined benefit obligations:		
Defined benefit obligations at 1 January	145	148
Interest cost	8	8
Actuarial loss / (gain)	34	(2)
Benefits paid	(3)	(3)
Foreign exchange rate changes	(1)	(6)
Defined benefit obligations at 31 December	183	145

Changes in the fair value of plan assets were as follows:

	2011 $millions	2010 $millions
Reconciliation of fair value of plan assets:		
Fair value of plan assets at 1 January	167	151
Expected return on plan assets	8	6
Actuarial gains	49	9
Employer contributions	10	9
Benefits paid	(3)	(3)
Foreign exchange rate changes	(2)	(5)
Fair value of plan assets at end of the year	229	167
Actual return on plan assets	57	15

34. RETIREMENT BENEFITS (CONTINUED)

Retirement benefit obligation (continued)

Plans operated by fellow Morgan Stanley undertakings (continued)

The major categories of the total plan assets are as follows:

	Fair value of assets 2011 $millions	2010 $millions
Equity securities	2	3
Fixed income securities	227	164
	229	167

The following table presents the principal actuarial assumptions at the date of the statement of financial position:

	2011	2010
Pre-retirement discount rate	4.60%	5.60%
Post-retirement discount rate	3.60%	4.30%
Inflation assumption	3.60%	3.60%
Expected rate of return on plan assets:		
- Equity securities	7.00%	7.00%
- Fixed income securities	3.20%	4.30%

The mortality assumptions used give the following life expectations at 65:

	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
	Aged 65	Aged 40	Aged 65	Aged 40
31 December 2011				
UK	89.2	92.2	91.9	94.8
31 December 2010				
UK	89.2	92.1	91.7	94.7

The sensitivities regarding the principal assumptions used to measure the defined benefit obligation are as follows:

Assumption	Change in assumption	Impact on scheme liabilities
Discount rate	Increase by 0.25% / decrease by 0.25%	Decrease by 8.25% / decrease by 9.08%
Inflation assumption	Increase by 0.25% / decrease by 0.25%	Increase by 4.84% / decrease by 4.41%
Rate of mortality	Increase by 1 year	Increase by 2.46%

34. RETIREMENT BENEFITS (CONTINUED)

Retirement benefit obligation (continued)

Plans operated by fellow Morgan Stanley undertakings (continued)

The five-year history of experience adjustments is as follows:

	2011 $millions	2010 $millions	2009 $millions	2008 $millions	2007 $millions
Present value of defined benefit obligation	(183)	(145)	(148)	(131)	(170)
Fair value of plan assets	229	167	151	149	195
Surplus	46	22	3	18	25
Experience adjustments on plan liabilities:					
Amount ($millions)	2	(10)	-	-	(6)
Percentage of plan liabilities (%)	1.10%	(7.12%)	0%	0%	(3.51%)
Experience adjustments on plan assets					
Amount ($millions)	(48)	(9)	27	1	5
Percentage of plan assets (%)	(20.80%)	(5.18%)	17.86%	0.68%	2.74%

35. RELATED PARTY DISCLOSURES

Parent and ultimate controlling entity

The Group's immediate parent undertaking is Morgan Stanley UK Group, which is registered in England and Wales. Copies of its accounts can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Maindy, Cardiff CF14 3UZ.

The ultimate parent undertaking and controlling entity and the largest group of which the Group is a member and for which group financial statements are prepared is Morgan Stanley. Morgan Stanley is incorporated in the state of Delaware, the United States of America and copies of its financial statements can be obtained from 25 Cabot Square, Canary Wharf, London E14 4QA.

35. RELATED PARTY DISCLOSURES (CONTINUED)

Subsidiaries

The principal subsidiary undertakings of the Group are as follows:

Name of Company	Country of Incorporation	Holding (per share class)	Type of shares held	Proportion of voting rights	Nature of business
Morgan Stanley Bowline Limited	United Kingdom	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Derivative Products (Netherlands) BV	The Netherlands	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Equity Finance (Denmark) ApS	Denmark	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Equity Financing Services (Sweden) AB	Sweden	100%	Ordinary Shares	100%	Investment company
Morgan Stanley (France) SAS	France	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Havel GmbH	Germany	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Kochi Limited	Cayman Islands	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Langton Limited	United Kingdom	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Longcross Limited	United Kingdom	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Mandarin Limited	United Kingdom	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Rivelino Investments Limited	United Kingdom	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Silvermere Limited	United Kingdom	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Taiwan Limited	Taiwan	100%	Ordinary Shares	100%	Financial Services
Morgan Stanley Turnberry Limited	United Kingdom	100%	Ordinary Shares	100%	Investment company
Morgan Stanley Waterloo Limited	Cayman Islands	100%	Ordinary Shares	100%	Investment company

A full list of the Company's subsidiary and associated undertakings will be annexed to the Company's next annual return and filed with the Registrar of Companies. All subsidiaries are included in the Group's consolidated financial statements.

During the year there were no investments where the Group owned more than 50% of the voting rights which were not classified as subsidiaries. During 2011 and 2010, none of the Group's subsidiaries has experienced significant restrictions on paying dividends or repaying loans and advances.

Key management compensation

Key management personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Group.

The Morgan Stanley Group's corporate governance framework gives consideration to legal, geographical and business lines through a combination of boards of directors, and regional and global management committees. Accordingly, in addition to the Directors of the Company, key management personnel of the Group is considered to include the boards of directors of certain parent companies, including that of Morgan Stanley, certain members of key Morgan Stanley Group management committees, and certain executive officers of Morgan Stanley.

The boards of the Group's parent companies, the management committees and the executive officers cover the full range of the Morgan Stanley Group's business activities. Only those members with responsibility for the Institutional Securities business, being the only reportable business segment of the Group, are considered to be key management personnel of the Group. The aggregate compensation below represents the proportion of compensation paid to these key management personnel, including the Directors of the Company, in respect of their services to the Group.

35. RELATED PARTY DISCLOSURES (CONTINUED)

Key management compensation (continued)

Compensation paid to key management personnel in respect of their services rendered to the Group is:

	2011 $millions	2010 $millions
Short-term employee benefits	29	31
Post-employment benefits	1	1
Share-based payments	37	21
Other long-term employee benefits	47	11
Termination benefits	-	2
	114	66

The share-based payment costs disclosed above reflect the amortisation of equity-based awards granted to key management personnel over the last three years and are therefore not directly aligned with other staff costs in the current year.

Key management personnel compensation is borne by other Morgan Stanley Group undertakings in both the current and prior years.

Directors' emoluments

	2011 $millions	2010 $millions
Total emoluments of all Directors:		
Aggregate emoluments	7	11
Long term incentive schemes	3	3
	10	14
Disclosures in respect of the highest paid Director:		
Aggregate emoluments excluding pension contributions	2	4
Long term incentive schemes	1	2
Aggregate compensation paid to Directors for loss of office	-	2

Directors' emoluments have been calculated as the sum of cash, bonuses and benefits in kind.

Directors who are employees of the Morgan Stanley Group are eligible for shares and share options of the parent company, Morgan Stanley, awarded under the Morgan Stanley Group's equity-based long-term incentive schemes. In accordance with Schedule 5 paragraph 1(3)(a) of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the above disclosures include neither the value of shares or share options awarded, nor the gains made on exercise of share options. During the year no Directors exercised share options awarded under these incentive schemes, including the highest paid Director (2010: none).

35. RELATED PARTY DISCLOSURES (CONTINUED)

Key management compensation (continued)

The value of assets (other than shares or share options) awarded under other long term incentive schemes has been included in the above disclosures when the awards vest, which is generally within three years from the date of the award.

There are nine directors to whom retirement benefits are accruing under a money purchase scheme (2010: six). No Directors have benefits accruing under the Alternative Retirement Plan, a defined benefit scheme, operated by Morgan Stanley UK Limited (2010: one). In addition, four directors have benefits accruing under the Morgan Stanley non-UK defined benefits schemes (2010: three).

The Company has provided no loans or other credit advances to its Directors during the year.

Transactions with related parties

The Morgan Stanley Group conducts business for clients globally through a combination of both functional and legal entity organisational structures. Accordingly, the Group is closely integrated with the operations of the Morgan Stanley Group and enters into transactions with other Morgan Stanley Group undertakings on an arm's length basis for the purposes of utilising financing, trading and risk management, and infrastructure services. The nature of these relationships along with information about the transactions and outstanding balances is given below. The Group has not recognised any expense and has made no provision for impairment relating to the amount of outstanding balances from related parties (2010: nil).

Funding

The Group receives funding from and provides funding to other Morgan Stanley Group undertakings in the following forms:

General funding

General funding is undated, unsecured, floating rate lending. Funding may be received or provided for specific transaction related funding requirements, or for general operational purposes. The interest rates are established by the Morgan Stanley Group Treasury function for all entities within the Morgan Stanley Group and approximate the market rate of interest that the Morgan Stanley Group incurs in funding its business.

Details of the outstanding balances on these funding arrangements and the related interest income or expense recognised in the consolidated income statement during the year are shown in the table below:

	2011		2010	
	Interest $millions	Balance $millions	Interest $millions	Balance $millions
Amounts due from the Group's direct and indirect parent companies	39	1,887	61	7,667
Amounts due from other Morgan Stanley Group undertakings	85	3,298	118	3,082
	124	5,185	179	10,749
Amounts due to the Group's direct and indirect parent companies	373	5,447	228	1,017
Amounts due to other Morgan Stanley Group undertakings	386	12,367	369	20,414
	759	17,814	597	21,431

35. RELATED PARTY DISCLOSURES (CONTINUED)

Funding (continued)

Subordinated loans

The Group receives subordinated loans from other Morgan Stanley Group undertakings. Details of the terms of such loans, including the contractual maturity and the interest rates are provided in note 16. The interest rates are established by the Morgan Stanley Group treasury function based on available market information at the time the loan is provided.

Trading and risk management

In the course of funding its business, the Group enters into collateralised financing transactions with other Morgan Stanley Group undertakings. All such transactions are entered into on an arm's length basis. Details of the outstanding balances on such transactions and related interest income / expense recognised in the consolidated income statement during the year are shown in the table below:

	2011		2010	
	Interest $millions	Balance $millions	Interest $millions	Balance $millions
Amounts due from other Morgan Stanley Group undertakings	974	48,814	1,326	43,349
Amounts due to other Morgan Stanley Group undertakings	1,735	60,865	1,910	77,471

The Group enters into purchases and sales of securities and derivative transactions with other Morgan Stanley Group undertakings to facilitate the provision of financial services to clients on a global basis and to manage the market risks associated with such business. All such transactions are entered into on an arm's length basis. The total amounts receivable and payable on such securities transactions not yet settled and the fair value of such derivatives contracts outstanding at the year-end were as follows:

	2011 $millions	2010 $millions
Amounts due from the Group's direct and indirect parent companies on unsettled securities and derivatives transactions	977	1,449
Amounts due from other Morgan Stanley Group undertakings on unsettled securities and derivatives transactions	127,748	57,023
	128,725	58,472
Amounts due to the Group's direct and indirect parent companies on unsettled securities and derivatives transactions	1,884	1,515
Amounts due to other Morgan Stanley Group undertakings on unsettled securities and derivatives transactions	130,730	55,484
	132,614	56,999

35. RELATED PARTY DISCLOSURES (CONTINUED)

Trading and risk management (continued)

The Group has received collateral of $9,205 million (2010: $5,084 million) from other Morgan Stanley Group undertakings and has pledged collateral of $8,961 million (2010: $5,306 million) to other Morgan Stanley Group undertakings to mitigate credit risk on exposures arising under derivatives contracts between the Group and other Morgan Stanley Group undertakings.

In addition, 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 year ended 31 December 2011, $949 million was transferred to other Morgan Stanley Group undertakings relating to such policies and recognised in the consolidated income statement (2010: $810 million was transferred to other Morgan Stanley Group undertakings).

Infrastructure services

The Group receives and incurs management charges to and from other Morgan Stanley Group undertakings for infrastructure services, including the provision of staff and office facilities. Management recharges received and incurred during the year are as follows:

	2011		2010	
	Staff costs $millions	Other services $millions	Staff costs $millions	Other services $millions
Amounts recharged from the Group's direct and indirect parent companies	-	201	-	181
Amounts recharged from other Morgan Stanley Group undertakings	1,511	123	1,731	125
	1,511	324	1,731	306

Amounts outstanding at the balance sheet date are included within the general funding balances disclosed above.

Other related party transactions

The Group has received a guarantee from Morgan Stanley International Limited, to guarantee the obligations under derivative contracts of Morgan Stanley Capital Services Inc., Morgan Stanley Capital Group Inc., MSDW Equity Finance Services (Cayman) Limited, MSDW Equity Finance Services (Lux) S.A.R.L. and Morgan Stanley Asia Securities Products LLC to Morgan Stanley & Co. International plc. All entities are fellow Morgan Stanley Group undertakings. As at 31 December 2011, no call had been made by the Group under this arrangement.

MORGAN STANLEY & CO. INTERNATIONAL plc
Registered Number: 2068222

COMPANY BALANCE SHEET
31 December 2011

	Note	2011 $millions	2010 $millions
FIXED ASSETS			
Tangible assets	3	8	8
Investments:			
- Available-for-sale financial assets	4	67	44
- Subsidiary undertakings	4	87	88
		162	140
CURRENT ASSETS			
Financial assets classified as held for trading (of which approximately $33,132 million (2010: $51,974 million) were pledged to various parties)	5	350,536	252,602
Financial assets designated at fair value through profit or loss	6	8,562	9,359
Loans and receivables:			
- Cash at bank	7	10,943	10,225
- Debtors	8	217,369	225,686
Other assets	9	313	311
		587,723	498,183
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR			
Financial liabilities classified as held for trading	5	331,755	216,527
Financial liabilities designated at fair value through profit or loss	6	7,176	11,306
Financial liabilities at amortised cost	11	219,536	252,401
Other creditors	12	171	434
		558,638	480,668
NET CURRENT ASSETS		29,085	17,515
TOTAL ASSETS LESS CURRENT LIABILITIES		29,247	17,655
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Financial liabilities designated at fair value through profit or loss	6	2,896	-
Financial liabilities at amortised cost	11	13,073	8,692
PROVISIONS FOR LIABILITIES AND CHARGES	13	8	28
NET ASSETS EXCLUDING PENSION LIABILITY		13,270	8,935
Pension liability		3	4
NET ASSETS		13,267	8,931
CAPITAL AND RESERVES			
Called up share capital	14	9,464	5,578
Share premium account	15	513	513
Capital redemption reserve	15	1,399	1,399
Foreign currency revaluation reserve	15	(77)	(66)
Fair value reserve	15	21	(3)
Capital contribution reserve	15	3	3
Profit and loss account	15	1,944	1,507
SHAREHOLDERS' FUNDS		13,267	8,931

These financial statements were approved by the Board and authorised for issue on 23 April 2012
Signed on behalf of the Board

Director CDS BRUCE

The notes on pages 95 to 119 form an integral part of the financial statements.

1. ACCOUNTING POLICIES

The Company's principal accounting policies are summarised below and have been applied consistently throughout the year and preceding year.

a. Basis of preparation

The financial statements are prepared under the historical cost convention, modified by the inclusion of financial instruments at fair value as described in note 1(e) below, and in accordance with applicable United Kingdom company law and accounting standards.

The Company's ultimate UK parent undertaking, Morgan Stanley International Limited, presents information in accordance with Financial Reporting Standard ("FRS") 29 *Financial instruments: Disclosures.* Accordingly, the Company is exempt from the disclosure requirements of FRS 29.

b. The going concern assumption

The Company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review section of the consolidated Directors' report on pages 1 to 10.

As set out in the Directors' report, retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Company's strategy and steps have been taken to strengthen both the Morgan Stanley Group and the Company's capital positions.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Company 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 annual report and financial statements.

c. Functional currency

Items included in the financial statements are measured and presented in US dollars, the currency of the primary economic environment in which the Company operates. All currency amounts in the financial statements are rounded to the nearest million US dollars.

d. Foreign currencies

All monetary assets and liabilities denominated in currencies other than US dollars are translated into US dollars at the rates ruling at the balance sheet date. Assets and liabilities of foreign operations are translated into US dollars using the closing rate method. Transactions in currencies other than US dollars are recorded at the rates prevailing at the dates of the transactions. Translation differences arising from the net investments in the foreign operations are taken to the 'Foreign currency revaluation reserve'. Foreign exchange differences on financial assets classified as available-for-sale are recorded in the 'Fair value reserve' in equity, with the exception of translation differences on the amortised cost of the monetary available-for-sale assets, which are recognised through the profit and loss account. All other translation differences are taken through the profit and loss account. Exchange differences recognised in the profit and loss account are presented in 'Other income' or 'Other expense', except where noted in 1(e) below.

1. ACCOUNTING POLICIES (CONTINUED)

e. Financial instruments

The Company classifies its financial assets into the following categories on initial recognition: financial assets classified as held for trading; financial assets designated at fair value through profit or loss; available-for-sale fixed asset investments; investments in subsidiary and associated undertakings and loans and receivables.

The Company classifies its financial liabilities into the following categories on initial recognition: financial liabilities classified as held for trading, financial liabilities designated at fair value through profit or loss and financial liabilities at amortised cost.

More information regarding these classifications is included below:

(i) Financial instruments classified as held for trading

With the exception of loans, financial instruments classified as held for trading, including all derivatives, are initially recorded on trade date at fair value (see note 1(f) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends, are reflected in the profit and loss account in 'Net gains / (losses) on financial instruments classified as held for trading'.

For loans classified as held for trading, from the date a loan's terms are agreed (trade date), until the loan is funded (settlement date), the Company recognises any unrealised fair value changes in the loan as financial instruments classified as held for trading. On settlement date, the fair value of consideration given or received is recognised as a financial instrument classified as held for trading. All subsequent changes in fair value, foreign exchange differences and interest are reflected in the profit and loss account in 'Net gains / (losses) from financial instruments classified as held for trading'.

For all financial instruments classified as held for trading, transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the profit and loss account in 'Other Expense'.

(ii) Financial instruments designated at fair value through profit or loss

The Company has designated certain financial assets and financial liabilities at fair value through profit or loss when:

- the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation at fair value eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

From the date the transaction in a financial instrument designated at fair value is entered into (trade date) until settlement date, the Company recognises any unrealised fair value changes in the contract as financial instruments designated at fair value through profit or loss. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at fair value through profit or loss (see note 1(f) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends, are reflected in the profit and loss account in 'Net gains / (losses) on financial instruments designated at fair value through profit or loss'. Transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the profit and loss account in 'Other Expense'.

1. ACCOUNTING POLICIES (CONTINUED)

e. Financial instruments (continued)

(iii) Available-for-sale fixed asset investments

Financial assets classified as available-for-sale are non-derivative financial assets that are either designated in this category or not classified in any of the other categories of financial instruments. Financial assets classified as available-for-sale are recorded on trade date and are initially recognised and subsequently measured at fair value (see note 1(f) below).

For debt instruments, interest calculated using the effective interest method (see note 1(e)(v) below), impairment losses and reversals of impairment losses and exchange differences on the amortised cost of the asset are recorded in the profit and loss account in 'Net gains / (losses) on fixed asset investments in available-for-sale financial assets'. For equity instruments, dividend income and impairment losses are recorded in the profit and loss account in 'Net gains / (losses) on fixed asset investments in available-for-sale financial assets'. All other gains and losses on debt and equity instruments classified as available-for-sale are recognised in the 'Fair value reserve' within equity.

Transaction costs that are directly attributable to the acquisition of the available-for-sale fixed asset investment are added to the fair value on initial recognition.

On disposal or impairment of an available-for-sale financial asset, the cumulative gain or loss in the 'Fair value reserve' is transferred to and recognised in the profit and loss account and reported in 'Net gains / (losses) on fixed asset investments in available-for-sale financial assets'.

(iv) Investments in subsidiary undertakings

Investments in subsidiary undertakings outside the scope of FRS 26 *Financial instruments: recognition and measurement* ("FRS 26"), are recorded within 'Investments in subsidiary undertakings' and are stated at cost, less provision for any impairment. Interest (recognised on an accruals basis), dividend income (recognised when the Company's right to receive payment is established), impairment losses, reversals of impairment losses, and foreign exchange differences on monetary investments are all reported in the profit and loss account in 'Net gains / (losses) on fixed asset investments in subsidiary undertakings'.

All other investments in Morgan Stanley Group undertakings are classified as available-for-sale fixed asset investments and accounted for as described in note 1(e)(iii).

(v) Loans and receivables and financial liabilities at amortised cost

Financial assets classified as loans and receivables are initially recognised on settlement date at fair value (see note 1(f) below) and subsequently measured at amortised cost less allowance for impairment. Interest is recognised in the profit and loss account in 'Interest income', using the effective interest method. Transaction costs that are directly attributable to the acquisition or issue of the financial asset are added to or deducted from the fair value on initial recognition. Impairment losses and reversals of impairment losses on financial assets classified as loans and receivables are recognised in the profit and loss account in 'Other expense'.

Financial liabilities held at amortised cost are initially recognised on settlement date at fair value (see note 1(f) below) and subsequently measured at amortised cost. Interest is recognised in the profit and loss account in 'Interest expense' using the effective interest rate method as described below. Transaction costs that are directly attributable to the issue of the financial liability are added to or deducted from the fair value on initial recognition.

The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the expected life of the financial asset or financial liability. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability (or, where appropriate a shorter period) to the carrying amount of the financial asset or financial liability. The effective interest rate is established on initial recognition of the financial asset and liability. The calculation of the effective interest rate includes all fees and commissions paid or received, transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability.

1. ACCOUNTING POLICIES (CONTINUED)

e. Financial instruments (continued)

(v) Loans and receivables and financial liabilities at amortised cost (continued)

In the course of financing its business and as part of its trading activities, the Company enters into arrangements which involve the sale of securities with agreements to repurchase, the purchase of securities with resale agreements, the lending of securities with collateral received and the borrowing of securities with collateral given. Cash collateral balances repayable and accrued interest arising under repurchase agreements and securities lending arrangements are classified as 'Financial liabilities at amortised cost' and the related securities, where owned by the Company, are included in 'Financial assets classified as held for trading'. Cash collateral balances receivable and accrued interest arising under resale agreements and securities borrowing arrangements are classified as debtors within 'Loans and receivables'. Securities received by the Company under resale arrangements and securities borrowing arrangements are generally not recognised on the balance sheet.

The redeemable preference shares issued by the Company were classified as financial liabilities at amortised cost in accordance with the substance of the contractual arrangement. Dividends on these redeemable preference shares were recognised in the profit and loss account in 'Interest expense' using the effective interest rate method. These shares were exchanged for ordinary shares during the year.

f. Fair value of financial instruments

Fair value measurement

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

In determining fair value, the Company uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that maximises the use of relevant observable inputs and minimises the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions other market participants would use in pricing the asset or liability, developed based on the best information available in the circumstances.

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

The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation the observability of prices and inputs may be reduced for many instruments.

Valuation techniques

Fair value for many cash and OTC contracts, is derived using pricing models. Pricing models take into account the contract terms (including the maturity), as well as multiple inputs including, where applicable, commodity prices. equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk. Adjustments for liquidity risk adjust model-derived valuations of financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trader activity, broker quotes or other external third-party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions.

1. ACCOUNTING POLICIES (CONTINUED)

f. Fair value of financial instruments (continued)

Valuation techniques (continued)

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

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

Gains and losses on inception

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Company recognises a gain or loss on inception of the transaction.

When unobservable market data has a significant impact on determining fair value at the inception of the transaction, the entire initial gain or loss indicated by the valuation technique as at the transaction date is not recognised immediately in the profit and loss account and is recognised instead when the market data becomes observable.

g. Impairment of financial assets

At each balance sheet date, an assessment is made as to whether there is any objective evidence of impairment in the value of financial assets classified as either available-for-sale, fixed asset investments, other fixed asset investments or loans and receivables. Impairment losses are recognised if an event has occurred which will have an adverse impact on the expected future cash flows of an asset and the expected impact can be reliably estimated.

Impairment losses on available-for-sale fixed asset investments are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value. When a decline in the fair value of an available-for-sale financial asset has been recognised through the statement of total recognised gains and losses and there is evidence that the asset is impaired, the cumulative loss that had been recognised through the statement of total recognised gains and losses is removed from reserves and recognised in the profit and loss account within 'Net gains / (losses) on fixed asset investments in available-for-sale financial assets'.

1. ACCOUNTING POLICIES (CONTINUED)

g. Impairment of financial assets (continued)

Impairment losses on fixed asset investments in subsidiary and associated undertakings, measured as the difference between cost and the current estimated recoverable amount, are recognised within the profit and loss account in 'Net gains and losses on fixed asset investments in subsidiary and associated undertakings' and are reflected against the carrying amount of the impaired asset on the balance sheet.

Impairment losses on loans and receivables carried at amortised cost are measured as the difference between the carrying amount of the financial asset and the present value of estimated cash flows discounted at the asset's original effective interest rate. Such impairment losses are recognised in the profit and loss account within 'Other expenses' and are reflected against the carrying amount of the impaired asset on the balance sheet. Interest on the impaired asset continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset.

Subsequent increases in fair value of previously impaired equity available-for-sale financial assets are reported as fair value gains in the statement of total recognised gains and losses and not separately identified as an impairment reversal. For all other financial assets, if in a subsequent year, the amount of the estimated impairment loss decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed as detailed by financial asset in note 1(e) (iii, iv and v). Any reversal is limited to the extent that the value of the asset may not exceed the original amortised cost of the asset had no impairment occurred.

h. Fees and commissions

Fees and commissions classified within 'Other income' in the profit and loss account include account servicing fees, investment management fees, sales commissions, placement fees, advisory fees and syndication fees. Fees and commissions classified within 'Other expense' include transaction and service fees. These amounts are recognised as the related services are performed or received.

i. Tangible fixed assets

Tangible fixed assets are stated at cost net of depreciation and any provision for impairment in value, which are included within 'Other Expense' in the profit and loss account. For assets in the course of construction, interest that is directly attributable to the construction of the qualifying asset is capitalised as a cost of the asset. The interest capitalisation rate is based on the Morgan Stanley Group's blended funding rates.

For premises held under operating leases, a reinstatement provision is recognised for the estimated cost to reinstate the premises at the end of the lease period. When the reinstatement provision is established and included within 'Provisions for liabilities in the balance sheet, an equivalent asset is recognised and included in the cost of leasehold improvements at the initial present value of any reinstatement obligations. The discount effect included in the reinstatement provision is reversed over time using a constant effective yield method and included within 'Interest expense' in the profit and loss account. The reinstatement asset is depreciated over the useful economic life of the relevant leasehold improvement asset and the depreciation charge is included within 'Other expense'.

Depreciation is provided on tangible fixed assets at rates calculated to write off the cost of the assets on a straight line basis over their expected useful lives as follows:

Leasehold improvements	- shorter of remaining lease term and 25 years
Fixtures, fittings and equipment	- 3 to 8 years

Assets in the course of construction are not depreciated until the construction is complete and the asset is ready for use. The asset is then transferred to leasehold improvements or fixtures, fittings and equipment, where it is depreciated at the relevant rate.

1. ACCOUNTING POLICIES (CONTINUED)

j. Operating leases

Rentals payable under operating leases are charged to 'Other expense' in the profit and loss account on a straight-line basis over the lease term. Lease incentives are recognised as a reduction of rentals payable and are allocated on a straight line basis over the shorter of the lease term and a period ending on a date from which it is expected the market rent will be payable.

Rentals receivable under operating leases are credited to 'Other income' in the profit and loss account on a straight-line basis over the lease term. Lease incentives are recognised as a reduction of rentals receivable and are allocated on a straight line basis over the shorter of the lease term and a period ending on a date from which it is expected the market rent will be receivable.

k. Taxation

UK corporation tax is provided at amounts expected to be paid / recovered using the tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

Full provision has been made for deferred tax assets and liabilities arising from timing differences. Deferred tax is measured using the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax assets and liabilities are not discounted.

Current tax assets are offset against current tax liabilities when there is a legally enforceable right to offset current tax assets against current tax liabilities and when they relate to taxes levied by the same taxation authority and the Company intends to settle its current tax assets and current tax liabilities on a net basis. Deferred tax assets are offset against deferred tax liabilities to the extent that they relate to taxes levied by the same tax authority and arise in the same taxable entity.

l. Employee compensation plans

(i) Equity settled share based compensation plans

Morgan Stanley operates equity based compensation plans on behalf of the Company, in relation to which, the Company pays Morgan Stanley in consideration of the procurement of the transfer of shares to employees. The cost of equity based transactions with employees is measured based on the fair value of the equity instruments at grant date. Fair value of stock unit awards is based on the market price of Morgan Stanley shares and the fair value of stock option awards is estimated using the Black-Scholes option pricing model, which takes into account the option's exercise price, its expected term, the risk free interest rate and the expected volatility of the market price of Morgan Stanley shares. Non-market vesting conditions are not taken into account when measuring fair value, but are reflected by adjusting over time the number of equity instruments included in the measurement of the transaction such that the amount ultimately recognised reflects the number that actually vest. The expense for FRS 20 *Share-based payment* ("FRS 20") purposes is taken directly to 'Other expense' in the profit and loss account; the corresponding credit to reserves is reduced to the extent that payments are due to Morgan Stanley in respect of these awards.

(ii) Other deferred compensation plans

Morgan Stanley also maintains deferred compensation plans for the benefit of certain employees that provide a return to the participating employees based upon the performance of various referenced investments. Liabilities for these awards, which are included within 'Accruals and deferred income' in the balance sheet, are measured at fair value and recognised over time in accordance with the awards' vesting conditions. The related expense is recorded within 'Staff costs' in 'Other expense'. The Company economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley undertakings. The derivatives are recognised within 'Financial instruments classified as held for trading' in the balance sheet and the related gains and losses are recorded within 'Net gains / loss on financial instruments classified as held for trading' in the profit and loss account.

Details of the plans are given in note 17 to these financial statements.

1. ACCOUNTING POLICIES (CONTINUED)

m. Retirement benefits

The Company operates defined contribution schemes. Contributions due in relation to the Company's defined contribution scheme are recognised in 'Other expense' in the profit and loss account when payable.

For the Company's defined benefit scheme, liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. A surplus of scheme assets over liabilities is recognised in the balance sheet as an asset where recoverable. Where scheme liabilities exceed scheme assets, the deficit is recognised in the balance sheet as a liability. The current service cost and any past service costs is charged to 'Other expense'. The expected return on scheme assets and the unwinding of the discount on the scheme liabilities are presented net and recognised within either 'Interest income' or 'Interest expense'. Actuarial gains and losses are recognised in full in the period in which they occur in the statement of recognised gains and losses.

Details of the plans are given in note 18 to these financial statements.

n. Cash flow statement

The Company's ultimate parent undertaking produces consolidated financial statements in which the Company is included and which are publicly available. Accordingly, the Company, which is a wholly-owned subsidiary, has elected to avail itself of the exemption provided in FRS 1 (Revised 1996) *Cash flow statements* and not present a cash flow statement.

2. PROFIT FOR THE YEAR

As permitted by section 408 of the Companies Act 2006 the Company has elected not to present its own profit and loss account for the period. The Company reported a profit after tax for the year ended 31 December 2011 of $547 million (2010: $274 million profit).

3. TANGIBLE FIXED ASSETS

	Leasehold improvements $millions	Fixtures, fittings and equipment $millions	Total $millions
Cost			
At 1 January 2011	17	13	30
Additions	-	2	2
Foreign exchange revaluation	-	(1)	(1)
At 31 December 2011	17	14	31
Depreciation			
At 1 January 2011	11	11	22
Charge for the year	1	1	2
Foreign exchange revaluation	-	(1)	(1)
At 31 December 2011	12	11	23
Net book value			
At 31 December 2010	6	2	8
At 31 December 2011	5	3	8

4. FIXED ASSET INVESTMENTS

Fixed asset investments classified as available-for-sale

Fixed asset investments that are categorised as available-for-sale are corporate equities. Movements in fixed asset investments classified as available-for-sale during the year are as follows:

	2011 $millions	2010 $millions
Fair value		
At 1 January	44	41
Additions	-	7
Disposals	(1)	(8)
Changes in fair value:		
- recognised in the 'Fair value reserve'	24	4
At 31 December	67	44

Included in 'Available-for-sale financial assets' are listed investments of $2 million (2010: $4 million).

Fixed asset investments in subsidiary undertakings

	Subsidiary undertakings $millions	Total $millions
Cost		
At 1 January 2011	1,082	1,082
Disposals	(1)	(1)
At 31 December 2011	1,081	1,081
Impairment provisions		
At 1 January 2011	(994)	(994)
At 31 December 2011	(994)	(994)
Net book value		
At 31 December 2010	88	88
At 31 December 2011	87	87

Details of the significant subsidiary undertakings are provided in note 35 of the consolidated financial statements. A full list of the Company's subsidiary undertakings will be annexed to the Company's next annual return and filed with the Registrar of Companies.

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

Financial assets and financial liabilities classified as held for trading are summarised in the table below:

	2011		2010	
	Assets $millions	Liabilities $millions	Assets $millions	Liabilities $millions
Fair value				
Derivative financial instruments (listed and OTC):				
- Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	223,327	217,043	110,726	106,151
- Foreign exchange forward contracts and options	26,405	26,670	16,084	16,280
- Equity securities contracts (including equity swaps, warrants and options)	46,125	48,800	38,091	43,025
- Commodity forwards, options and swaps	13,959	13,742	21,024	20,487
	309,816	306,255	185,925	185,943
Government debt securities	9,248	10,208	16,369	15,105
Corporate and other debt	10,833	2,723	19,755	4,261
Corporate equities	20,639	12,569	30,553	11,218
Total financial instruments classified as held for trading	350,536	331,755	252,602	216,527

There are no terms and conditions of any financial asset or liability classified as held for trading that may individually significantly affect the amount, timing and certainty of future cash flows for the Company.

6. FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

Financial assets and financial liabilities designated at fair value through profit or loss are summarised in the table below:

	2011		2010	
	Assets $millions	Liabilities $millions	Assets $millions	Liabilities $millions
Fair value				
Prepaid OTC contracts	3,264	2,676	4,909	4,137
Structured notes	-	1,099	-	492
Corporate loans	1,377	-	-	-
Other financial assets and liabilities	3,921	6,297	4,450	6,677
Total financial instruments designated at fair value through profit or loss	8,562	10,072	9,359	11,306

The maximum exposure to credit risk of loans and receivables designated at fair value through profit or loss at the end of the year is $1,377 million (2010: $nil). The cumulative change in fair value of loans attributable to changes in credit risk amounts to a gain of $85 million (2010: $nil) and the change for the current year is a gain of $85 million (2010: $nil). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk.

Included within financial liabilities designated at fair value is an amount of $2,896 million (2010: $4,134 million) that is expected to be settled after more than twelve months.

The carrying amount of financial liabilities designated at fair value was $144 million lower than the contractual amount due at maturity (2010: $8 million lower).

6. FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS (CONTINUED)

The change in fair value recognised through the consolidated income statement attributable to own credit risk is a gain of $128 million (2010: $1 million loss) and cumulatively is $249 million gain (2010: $121 million gain). This change is determined as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk.

7. CASH AT BANK

Included within 'Cash at bank' is an amount of $8,171 million (2010: $7,238 million) which represents segregated client money, held in accordance with the FSA's Client Money Rules, and an amount of $8 million (2010: $40 million) which represents other client money.

8. DEBTORS

	2011 $millions	2010 $millions
Debtors classified within loans and receivables at amortised cost		
Trade debtors:		
- External counterparties	50,052	46,490
- Morgan Stanley Group undertakings	17,740	16,616
Securities purchased under agreements to resell and cash collateral on stocks borrowed:		
- External counterparties	81,271	92,793
- Morgan Stanley Group undertakings	58,683	54,009
Other amounts due from Morgan Stanley Group undertakings	7,692	13,099
Other debtors classified within loans and receivables	1,931	2,679
	217,369	225,686

9. OTHER ASSETS

	2011 $millions	2010 $millions
Corporation tax	122	158
Deferred taxation (see note 10)	28	27
Prepayments and accrued income	163	126
	313	311

10. DEFERRED TAX

Deferred tax has been fully recognised and is analysed as follows:

	2011 $millions	2010 $millions
Accelerated capital allowances	6	7
Deferred compensation	13	-
Other timing differences	9	20
	28	27

10. DEFERRED TAX (CONTINUED)

The movement in the deferred tax asset during the year is analysed as follows:

	Asset $millions
At 1 January 2011	27
Amounts recognised in the profit and loss account:	
- Current period timing differences	1
Amounts recognised in equity through the statement of total recognised gains and losses:	
- Current period timing differences	(2)
Prior year timing difference	2
Future tax charges on transitional accounting adjustments	1
Impact in change in tax rates	(1)
At 31 December 2011	28

Finance Act 2011 enacted a 1% reduction to the UK corporation tax rate to 25% with effect from April 2012. This rate reduction to 25% has had an impact on the Company's deferred tax balance as indicated above.

As part of the Budget announcements on 21 March 2012, a further 1% reduction in the rate of UK corporation tax to 24% was announced and substantively enacted on 26 March 2012. A further announcement to reduce the UK corporation tax rate to 23% and 22% from April 2013 and April 2014 respectively was also made. However, as these reductions were not substantively enacted as at 31 December 2011, the effect of these subsequent rate reductions has not been applied to the valuation of the Company's deferred tax assets and liabilities.

11. FINANCIAL LIABILITIES AT AMORTISED COST

	2011 $millions	2010 $millions
Financial liabilities at amortised cost falling due within one year		
Bank loans and overdrafts	124	60
Trade creditors:		
- External counterparties	61,251	56,576
- Morgan Stanley Group undertakings	23,200	19,519
Securities sold under agreements to repurchase and cash collateral on stocks loaned:		
- External counterparties	42,514	74,234
- Morgan Stanley Group undertakings	70,735	75,754
Other amounts owing to Morgan Stanley Group undertakings	17,876	23,170
Other financial liabilities	3,836	3,088
	219,536	252,401
Financial liabilities at amortised cost falling due after more than one year		
Financial instruments issued:		
- Subordinated loans	7,906	7,906
- Preference shares	-	786
Securities sold under agreements to repurchase and cash collateral on stocks loaned:		
- External counterparties	4,114	-
Other amounts owing to Morgan Stanley Group undertakings	1,053	-
	13,073	8,692
Total financial liabilities at amortised cost	232,609	261,093

Included within trade creditors owing to Morgan Stanley Group undertakings are amounts of $9,205 million (2010: $4,925 million) representing cash collateral received as security for open trading positions held with other Group undertakings.

11. FINANCIAL LIABILITIES AT AMORTISED COST

Subordinated loans

The amounts subject to subordinated loan agreements are wholly repayable as shown below:

Counterparty	Repayment Date	Interest Rate	2011 $millions	2010 $millions
Morgan Stanley UK Financing I LP	31 October 2025	LIBOR plus 1.25%	7,906	-
Morgan Stanley International Finance S.A.	31 October 2025	LIBOR plus 1.25%	-	7,906
			7,906	7,906

All amounts outstanding under subordinated loan agreements are repayable at any time at the Company's option, subject to two business days' notice to the lender and at least one month notice to the Financial Services Authority ("FSA"), which has the right under the agreement to refuse consent to repayment.

On 16 December 2011 Morgan Stanley International Finance S.A. novated the subordinated debt held by the Group to Morgan Stanley UK Financing I LP.

The Company has not had any defaults of principal, interest or other breaches with respect to its subordinated loans during the period.

Preference shares

	Total $millions
Allotted and fully paid:	
At 1 January 2011	786
Repurchased	(786)
31 December 2011	-

At 31 December 2010 the Company's issued share capital included 785,772,500 Class B non-cumulative preference shares of $1 each, classified as liabilities. On 22 December 2011 the Company repurchased the preference shares.

During the year, dividends of $18 million (2010: $21 million) were paid to the holders of the Class B redeemable non-cumulative preference shares.

12. OTHER CREDITORS

	2011 $millions	2010 $millions
Amounts falling due within one year		
Corporation tax	12	238
Accruals and deferred income	159	196
	171	434

13. PROVISIONS FOR LIABILITIES AND CHARGES

	Property $millions	Litigation $millions	Total $millions
At 1 January	2	26	28
Additional provisions	1	5	6
Provision utilised	-	(24)	(24)
Unused provisions reversed	-	(3)	(3)
Revaluation	-	1	1
At 31 December 2011	3	5	8

Litigation Matters

In the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and / or punitive damages or claims for indeterminate amounts of damages. While the Company has identified below any individual proceedings where the Company believes a material loss to be reasonably possible and reasonably estimable, there can be no assurance that material losses will not be incurred from claims that have not yet been notified to the Company or are not yet determined to be probable or possible and reasonably estimable. Any litigation matters and provisions have been recognised and disclosed in accordance with FRS 12 *'Provisions, Contingent Liabilities and Contingent Assets'*.

On 25 August 2008, the Morgan Stanley Group, the Company and two ratings agencies were named as defendants in a purported class action related to securities issued by a structured investment vehicle ("SIV") called Cheyne Finance (the "Cheyne SIV"). The case is styled *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.* and is pending in the SDNY. The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. On 2 September 2009, the court dismissed all of the claims against the Morgan Stanley Group and the Company except for plaintiffs' claims for common law fraud. On 15 June 2010, the court denied plaintiffs' motion for class certification. On 20 July 2010, the court granted plaintiffs leave to replead their aiding and abetting common law fraud claims against the Morgan Stanley Group and the Company, and those claims were added in an amended complaint filed on 5 August 2010. On 27 December 2011, the court permitted plaintiffs to reinstate their causes of action for negligent misrepresentation and breach of fiduciary duty against the Morgan Stanley Group and the Company. The Morgan Stanley Group and the Company moved to dismiss these claims on 10 January 2012. On 5 January 2012, the court permitted plaintiffs to amend their Complaint and assert a negligence claim against the Morgan Stanley Group and the Company. The amended complaint was filed on 9 January 2012 and the Morgan Stanley Group and the Company moved to dismiss the negligence claim on 17 January 2012. On 23 January 2012, the Morgan Stanley Group and the Company moved for summary judgment with respect to the fraud and aiding and abetting fraud claims. There are 15 plaintiffs in this action asserting claims related to approximately $983 million of securities issued by the Cheyne SIV. Plaintiffs have not alleged the amount of their alleged investments and are seeking, among other things, unspecified compensatory and punitive damages. Based on currently available information, the Morgan Stanley Group and the Company believes that the defendants could incur a loss up to the amount of plaintiffs' claimed compensatory damages, once specified, related to their alleged purchase of approximately $983 million of securities issued by the Cheyne SIV plus pre- and post-judgment interest, fees and costs.

13. PROVISIONS (CONTINUED)

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Morgan Stanley Group, which is styled *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al.* and is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a $275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Morgan Stanley Group misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Morgan Stanley Group knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately $228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional $12 million, punitive damages, equitable relief, fees and costs. On 28 February 2011, the court presiding over this action denied the Morgan Stanley Group's motion to dismiss the complaint. On 21 March 2011, the Morgan Stanley Group appealed the order denying its motion to dismiss the complaint. On 7 July 2011, the appellate court affirmed the lower court's decision denying the motion to dismiss. Based on currently available information, the Morgan Stanley Group believes it could incur a loss of up to approximately $240 million plus pre- and post-judgment interest, fees and costs.

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

In addition to the above the Company has identified the following proceeding.

On 10 June 2010, the Morgan Stanley Group and the Company was named as a new defendant in a pre-existing purported class action related to securities issued by a SIV called Rhinebridge plc ("Rhinebridge SIV"). The case is styled *King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al.* and is pending in the SDNY. The complaint asserts claims for common law fraud and aiding and abetting common law fraud and alleges, among other things, that the ratings assigned to the securities issued by the SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime RMBS held by the SIV. On 15 July 2010, the Morgan Stanley Group and the Company moved to dismiss the complaint. That motion was denied on 29 October 2010. On 27 December 2011, the court permitted plaintiffs to amend their complaint and assert causes of action for negligence, negligent misrepresentation, and breach of fiduciary duty against the Company. The amended complaint was filed on 10 January 2012 and the Morgan Stanley Group and the Company moved to dismiss the negligence, negligent misrepresentation, and breach of fiduciary duty claims on 31 January 2012. The case is pending before the same judge presiding over the litigation concerning the Cheyne SIV, described above. While reserving their ability to act otherwise, plaintiffs have indicated that they do not currently plan to file a motion for class certification. Plaintiffs have not alleged the amount of their alleged investments, and are seeking, among other relief, unspecified compensatory and punitive damages.

14. SHARE CAPITAL

	2011 $millions	2010 $millions
Allotted and fully paid:		
Equity shares		
6,884,105,148 ordinary shares of $1 each	6,884	2,998
17,615,107 ordinary shares of £1 each	30	30
1,500,000,000 Class A Non-voting ordinary shares of $1 each	1,500	-
50,000,000 Class C non-redeemable non-cumulative preferred shares of $1 each	50	50
2,500,000,000 Class D non-redeemable non-cumulative preferred shares of $1 each	-	2,500
1,000,000,000 Class D1 non-redeemable non-cumulative preferred shares of $0.4 each	1,000	-
Allotted and fully paid:	9,464	5,578

Voting rights:	2011
Ordinary shares of $1 each	69.59%
Ordinary shares of £1 each	0.41%
Class A Non-voting ordinary shares of $1 each	Non-voting
Class C non-redeemable non-cumulative preferred shares of $1 each	20%
Class D1 non-redeemable non-cumulative preferred shares of $0.4 each	10%
Total	100%

Equity shares

All ordinary shares are recorded at the rates of exchange ruling at the date the shares were paid up.

The holders of the ordinary shares, irrespective of currency denomination, are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company in accordance with the Company's articles of association.

On 22 December 2011 the Company entered into the following transactions:

- The terms of the Class C non-redeemable non-cumulative $1 preference shares have been amended so that the holders of such shares in issue shall carry 20% of the total voting rights of all the members of the Company having a right to attend and vote at general meetings.
- The 2,500,000,000 non-redeemable non-cumulative D preference shares of $1 were subdivided into 2,500,000,000 D1 preference shares of $0.4 with 10% of the total voting rights and 2,500,000,000 D2 preference shares of $0.6 with no voting rights.
- 785,772,500 ordinary shares of $1 were issued, the proceeds of which were used to repurchase the 785,772,500 non-voting B preference shares, previously classified as debt.
- 1,500,000,000 Class A non-voting ordinary shares of $1 were issued, the proceeds of which were used to repurchase the 2,500,000,000 non-voting D2 preference shares.
- 3,100,000,000 ordinary shares of $1 were issued.

On a return of capital, the holders of the Class C and Class D1 non-redeemable non-cumulative preference shares shall rank in priority to the ordinary shares.

15. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES

	Called up share capital $millions	Share premium account $millions	Foreign currency revaluation reserve $millions	Capital contribution reserve $millions	Capital redemption reserve $millions	Fair value reserve $millions	Profit and loss account $millions	Total $millions
Balance at 1 January 2010	3,078	513	(18)	3	1,399	(4)	1,592	6,563
Reclassification from currency translation reserve to retained earnings net of income tax	-	-	(45)	-	-	-	45	-
Profit for the year	-	-	-	-	-	-	274	274
Other comprehensive income:								
Foreign exchange differences arising on translation of net assets in overseas branches	-	-	(5)	-	-	-	-	(5)
Available-for-sale financial assets – net change in fair value recognised directly in equity	-	-	-	-	-	1	-	1
Actuarial loss recognised in defined benefit schemes	-	-	-	-	-	-	(3)	(3)
Income tax relating to components of other comprehensive income	-	-	2	-	-	-	-	2
Total comprehensive (loss) / income	-	-	(48)	-	-	1	316	269
Transactions with owners:								
Dividends	-	-	-	-	-	-	(401)	(401)
Preference share issue	2,500	-	-	-	-	-	-	2,500
Balance at 1 January 2011	5,578	513	(66)	3	1,399	(3)	1,507	8,931
Profit for the year	-	-	-	-	-	-	547	547
Other comprehensive income:								
Foreign exchange differences arising on translation of net assets in overseas branches	-	-	(8)	-	-	-	-	(8)
Available-for-sale financial assets – net change in fair value recognised directly in equity	-	-	-	-	-	24	-	24
Income tax relating to components of other comprehensive income	-	-	(3)	-	-	-	-	(3)
Total comprehensive (loss) / income	-	-	(11)	-	-	24	547	560
Transactions with owners:								
Dividends	-	-	-	-	-	-	(110)	(110)
Ordinary shares issued	5,386	-	-	-	-	-	-	5,386
Preference shares repurchased	(1,500)	-	-	-	-	-	-	(1,500)
Balance at 31 December 2011	9,464	513	(77)	3	1,399	21	1,944	13,267

15. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES (CONTINUED)

Foreign currency revaluation reserve

The 'foreign currency revaluation reserve' comprises all foreign exchange differences arising from the translation of the total assets less total liabilities of foreign operations denominated in currencies other than US dollars.

Fair Value reserve

The 'Fair value reserve' includes the cumulative net change in the fair value of available-for-sale financial assets held at the reporting date. The tax effect of these movements is also included in the 'Fair value reserve'.

16. COMMITMENTS AND CONTINGENCIES

During the next year the Company is committed to pay $9 million (2010: $7 million) in respect of operating leases as follows:

	Land and buildings 2011 $millions	Land and buildings 2010 $millions
Maturity of lease:		
Within one year	1	-
In two to five years	8	7
Over five years	-	-
	9	7

17. EMPLOYEE COMPENSATION PLANS

Equity settled share based compensation plans

Deferred stock awards

Morgan Stanley has made deferred stock awards pursuant to several equity-based compensation plans. The plans provide for the deferral of a portion of certain key employees' discretionary compensation with awards made in the form of a right to receive unrestricted shares of common stock in the future ("restricted stock units"). Awards under these plans are generally subject to vesting over time contingent upon continued employment and to restrictions on sale, transfer or assignment until the end of a specified period, generally two to three years from date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant restriction period. All or a portion of a vested award also may be cancelled in certain limited situations, including termination for cause during the relevant restriction period. Recipients of deferred stock awards generally have voting rights and receive dividend equivalents.

During the year Morgan Stanley granted 363,255 units of restricted stock units to employees of the Company with a weighted average fair value per unit of $29.16 (2010: 446,483 units, weighted average fair value $29.10), based on the market value of Morgan Stanley shares at grant date.

Stock option awards

Morgan Stanley has also granted stock option awards in the form of stock options on Morgan Stanley's common stock. The stock options generally have an exercise price of not less than the fair value of Morgan Stanley's common stock on the date of grant and generally become exercisable over a three year period, expiring ten years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are similar to those in deferred stock awards.

No options were granted in the current year (2010: none).

17. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Stock option awards (continued)

The following table shows activity relating to the Morgan Stanley Group's stock option awards for employees of the Company:

	2011		2010	
	Number of options '000s	Weighted average exercise price $	Number of options '000s	Weighted average exercise price $
Options outstanding at 1 January	111	52.93	169	55.53
Expired during the year	(9)	56.56	(58)	60.48
Options outstanding at 31 December	102		111	52.93
Options exercisable at 31 December	102		111	52.93

No stock options were exercised throughout the year (2010: none).

The following table presents information relating to the stock options outstanding:

	2011			2010		
Range of exercise prices	Number of options '000s	Weighted average exercise price $	Weighted average remaining life in years	Number of options '000s	Weighted average exercise price $	Weighted average remaining life in years
\$30.00 - \$39.99	19	36.33	1.0	19	36.33	2.0
\$40.00 - \$49.99	44	47.11	1.5	44	47.11	2.5
\$50.00 - \$59.99	-	-	-	7	55.61	0.0
\$60.00 - \$69.99	39	66.73	5.0	41	66.69	5.8
Total	102	52.60	2.7	111	52.93	3.4

17. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Other deferred compensation plans

The Company has granted deferred compensation awards to certain of its key employees. The plans provide for the deferral of a portion of the employees' discretionary compensation with awards that provide a return based upon the performance of various referenced investments. Awards under these plans are generally subject to a sole vesting condition of service over time, which normally ranges from six months to three years from the date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant vesting period. The awards are settled in cash at the end of the relevant vesting period.

Awards with a value of $11 million (2010: $7 million) have been granted to employees and an expense of $15 million (2010: $4 million) has been recognised within 'Staff costs' in 'Other expense' in the profit and loss account in relation to current year awards. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the balance sheet, is $18 million (2010: $14 million).

The Company economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial liabilities classified as held for trading' in relation to these deferred compensation schemes is $2 million (2010: $2 million) and the related profit and loss recorded within 'Net gains / losses on financial instruments classified as held for trading' for the year is $nil (2010: $1 million gain).

18. RETIREMENT BENEFITS

Defined contribution schemes

The Company operates several Morgan Stanley defined contribution schemes which require contributions made to the schemes to be held in trust, separate from the assets of the Company.

The defined contribution schemes are as follows:

Morgan Stanley Flexible Company Pension Plan (Amsterdam)

Morgan Stanley & Co. International plc, (Greece Branch) Group Insurance Policy

MSII Offshore Retirement Benefit Plan IV, Dubai Section

The Company pays fixed contributions to the funds, with no legal or constructive obligation to pay further contributions.

The defined contribution pension charge for the year was $1 million (2010: $1 million) of which $nil was accrued at 31 December 2010 (2010: $nil). Contributions to the Morgan Stanley & Co. International plc, (Greece Branch) Group Insurance Policy ceased during 2008 due to the closure of the branch.

Defined benefit schemes

The Company also operates several Morgan Stanley defined benefit schemes, which provide benefits that are based on an actuarial valuation. The Company's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations.

The defined benefits schemes are as follows:

Morgan Stanley & Co International plc Paris Branch IFC (Indemnites de Fin de Carriere)

Morgan Stanley Dubai End of Service Gratuity

Personalvorsorgestiftung der Bank Morgan Stanley AG Plan

18. RETIREMENT BENEFITS (CONTINUED)

Defined benefit schemes (continued)

During 2010, Bank Morgan Stanley AG transferred its institutional securities business to the Zurich Branch but its employees remained in the same Personalvorsorgestiftung der Bank Morgan Stanley AG Plan, together with all remaining Bank Morgan Stanley AG employees. The plan was considered as transferred into the Zurich Branch with the difference between assets and liabilities at initial recognition included in recognised gains and losses for the year.

The most recent full actuarial valuations of the defined benefit schemes were carried out at 31 December 2010. The liabilities of the schemes are measured by discounting the best estimate of future cash flows to be paid out by the scheme using the projected unit method. The projected unit method is an accrued benefits valuation method in which the scheme liabilities make allowance for projected earnings. The accumulated benefit obligation is an actuarial measure of the present value of benefits for service already rendered but differs from the projected unit method in that it includes no assumption for future salary increases.

Defined benefit scheme expense

The amounts recognised in profit or loss in respect of these defined benefit schemes are as follows:

	2011 $millions	2010 $millions
Current service cost	2	2
Past service cost	(1)	-
Interest on obligation	-	1
Total defined benefit scheme expense	1	3

Of the charge for the year, $1 million (2010: $2 million) has been included in 'Other expenses' and $nil (2010: $1 million) has been included in 'Interest expense'. Actuarial gains and losses of $nil (2010: $3 million loss) have been recognised in 'Statement of total recognised gains and losses'.

The cumulative amount of actuarial gains and losses recognised in the 'Statement of total recognised gains and losses' is $5 million loss (2010: $5 million loss).

Retirement benefit liability

The following table provides a reconciliation of the present value of scheme liabilities and fair value of scheme assets included in the balance sheet, as well as a summary of the funded status of the schemes:

	2011 $millions	2010 $millions
Present value of funded defined benefit obligation	(17)	(13)
Fair value of scheme assets	15	11
	(2)	(2)
Present value of unfunded defined benefit obligation	(1)	(2)
Retirement benefit liability recognised in the balance sheet	(3)	(4)

Contributions for the year to the closed defined benefit section of the Plan totalled $2 million (2010: $6 million), of which $nil was accrued at 31 December 2011 (2010: $nil). The Company expects to contribute $1 million (2010: $1 million) in the next financial year, based upon the current funded status and the expected return assumptions for the next financial year.

18. RETIREMENT BENEFITS (CONTINUED)

Reconciliation of defined benefit scheme liabilities

Changes in the present value of the defined benefit scheme obligations were as follows:

	2011 $millions	2010 $millions
Defined benefit obligation at 1 January	13	6
Current service cost	2	2
Past service cost	(1)	-
Interest cost	-	1
Net transfer in	2	11
Liabilities extinguished on settlements	-	(7)
Actuarial (gain) / loss	(1)	1
Plan participants' contributions	1	-
Benefits paid	-	(1)
Foreign exchange rate changes	2	-
Defined benefit obligation at 31 December	18	13

Changes in the fair value of scheme assets were as follows:

	2011 $millions	2010 $millions
Fair value of scheme assets at 1 January	9	2
Employer contributions	2	6
Actuarial loss	(1)	-
Benefits paid	-	(1)
Net transfer in	2	9
Assets distributed on settlements	-	(7)
Plan participants' contributions	1	-
Expected return on plan assets	-	1
Foreign exchange losses	2	(1)
Fair value of scheme assets at 31 December	15	9
Actual return on scheme assets	-	-

The major categories of scheme assets as a percentage of total scheme assets and the expected rates of return are as follows:

	Expected return		Fair value of assets	
	2011 %	2010 %	2011 $millions	2010 $millions
Equity securities	6.7%	7.65%	4	3
Fixed income securities	0.9%	1.87%	7	4
Real estate / property	6.1%	6.56%	1	-
Other – primarily cash	1.3%	1.88%	3	2
			15	9

The expected long-term rate of return on assets represents the Company's best estimate of the long-term return on scheme assets and generally was estimated by computing a weighted average return of the underlying long-term expected returns on the different asset classes, based on the target asset allocations. For schemes where there is no established target asset allocation, actual asset allocations were used. The expected long-term return on assets is a long-term assumption that generally is expected to remain the same from one year to the next unless there is a significant change in the target asset allocation, the fees and expenses paid by the plan or market conditions.

18. RETIREMENT BENEFITS (CONTINUED)

Actuarial assumptions

The following table presents the principal actuarial assumptions at the balance sheet date:

	2011	2010
Discount rate	2.50%-4.70%	2.75%-7.05%
Rate of increase in salaries	1.00%-4.00%	3.50%-5.50%
Inflation assumption	1.50%-2.00%	1.50%-3.5%
Expected long-term rate of return on scheme assets	-	-

The mortality assumptions used give the following life expectations:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
31 December 2011					
Switzerland	Swiss BVG 2010, Static Mortality Table	84.7	84.7	87.0	87.0
31 December 2010					
Switzerland	Unadjusted BVG 2005, Mortality Table	82.9	82.9	86.0	86.0

The sensitivities regarding the principal assumptions used to measure the scheme liabilities are as follows:

Switzerland Plan

	Change in assumption	Impact on scheme liabilities
Discount rate	Increase / decrease by 0.5%	Decrease by 7.5% / increase by 8.4%
Inflation assumption	Increase / decrease by 0.5%	Increase by 4.2% / decrease by 3.0%
Rate of increase in salaries	Increase / decrease by 0.5%	Increase by 0.7% / decrease by 0.7%
Rate of mortality	Increase by 1 year	Increase by 0.6%

Surplus / (deficit) and experience adjustments

The five-year history of experience adjustments is as follows:

	31 December 2011 $millions	31 December 2010 $millions	31 December 2009 $millions	31 December 2008 $millions	30 November 2007 $millions
Present value of defined benefit obligation	18	13	6	4	5
Fair value of scheme assets	15	9	2	2	2
Deficit	(3)	(4)	(4)	(2)	(3)
Experience adjustments on scheme liabilities:					
Amount ($'000)	(1)	592	(1,197)	132	(108)
Percentage of scheme liabilities (%)	(3%)	4%	(19%)	3%	(2%)
Experience adjustments on scheme assets:					
Amount ($'000)	-	(125)	112	(134)	(48)
Percentage of scheme assets (%)	(3%)	(1%)	6%	(7%)	(2%)

19. RELATED PARTY TRANSACTIONS

The Company is exempt from the requirement to disclose transactions with fellow wholly owned Morgan Stanley Group undertakings under paragraph 3(c) of FRS 8 *Related party disclosures*. There were no other related party transactions requiring disclosure.

20. PARENT UNDERTAKINGS

The ultimate parent undertaking and controlling entity and the largest group of which the Company is a member and for which group financial statements are prepared is Morgan Stanley. Morgan Stanley is incorporated in Delaware, the United States of America and copies of its financial statements can be obtained from 25 Cabot Square, Canary Wharf, London E14 4QA.

The Company's immediate controlling party is Morgan Stanley Group Europe, which is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Maindy, Cardiff CF14 3UZ.

The parent undertaking of the smallest group of companies for which group financial statements are drawn up and of which the Company is a member is Morgan Stanley International Limited which is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Maindy, Cardiff CF14 3UZ.