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Cayman Islands

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

Report and financial statements

31 December 2017

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

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MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STRATEGIC REPORT

The Directors present their Strategic report for Morgan Stanley Capital (Cayman Islands) Limited (the "Company") for the year ended 31 December 2017.

PRINCIPAL ACTIVITY

The Company is an exempted company incorporated under the laws of the Cayman Islands.

The principal activity of the Company is the issuance of Optimised Portfolios as Listed Securities ("OPALS") and the hedging of the obligations arising pursuant to such issuances with Equity Linked Obligations ("ELOs").

The Company's ultimate parent undertaking and controlling entity is Morgan Stanley, which, together with the Company and Morgan Stanley's other subsidiary undertakings, form the "Morgan Stanley Group".

There have not been any significant changes in the Company's principal activity in the year under review and no significant change in the Company's principal activity is expected.

BUSINESS REVIEW

On 23 June 2016, the United Kingdom (the "UK") electorate voted to leave the European Union (the "EU"). On 29 March 2017, the UK invoked Article 50 of the Lisbon Treaty which triggered a two-year period, subject to extension, (which would need the unanimous approval of the EU Member States), during which the UK government is expected to negotiate its withdrawal agreement with the EU. Absent any extension, the UK is expected to leave the EU in March 2019. The terms and conditions of the anticipated withdrawal from the EU, and which of the several alternative models of relationship that the UK might ultimately negotiate with the EU, remain uncertain. However, the UK government has stated that the UK will leave the EU single market and will seek a phased period of implementation for the new relationship that may cover the legal and regulatory framework applicable to financial institutions with significant operations in Europe, such as Morgan Stanley. Since any transition or implementation periods and the eventual successor arrangements require agreement of both the UK and the EU, there is a risk that these arrangements may not be agreed by March 2019.

It is difficult to predict the future of the UK's relationship with the EU, which may result in increased volatility in the global financial markets in the short-and medium-term. Potential effects of the UK exit from the EU and potential mitigation actions may vary considerably depending on the timing of withdrawal and the nature of any transition, implementation or successor arrangements. Morgan Stanley is taking steps to make changes to its European operations in an effort to ensure that it can continue to provide cross border banking and investment services in EU Member States without the need for separate regulatory authorisations in each member state. These changes must be approved by the relevant regulatory authorities and therefore it is currently unclear what the final post-Brexit structure of European operations will be. Depending on the extent to which Morgan Stanley may be required to make changes to European operations beyond those currently planned, results of Morgan Stanley's operations and business prospects could be negatively affected.

Overview of 2017

The statement of comprehensive income is set out on page 14. The Company's result for the year is \$nil which is consistent with the Company's function and the prior year. Interest income increased by \$10,000 and interest expense increased by \$14,000 compared to 31 December 2016. This is due to an increase in the average outstanding loan receivable and payable balances with other Morgan Stanley Group undertakings during the year when compared to the prior year along with an increase in interest rates in the current year. In addition there were foreign exchange gains of \$4,000 reported in the current year.

The statement of financial position is set out on page 16. The Company has reported a decrease in the level of OPALS in issuance compared with 2016. As a result, the value of financial assets and financial liabilities designated at fair value through profit or loss, which are represented by ELOs and OPALS respectively, have decreased from \$2,764,433,000 to \$1,544,277,000 at 31 December 2017. The decrease in OPALS is due to fair value movements, issuances and redemptions during the year, which has resulted in a corresponding decrease in ELOs. Other receivables and other payables have both decreased by \$3,088,000 following the settlement of balances.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

The performance of the Company 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 US Securities and Exchange Commission. The Morgan Stanley Group manages its key performance indicators on a global basis but in consideration of individual legal entities. For this reason, the Company's Directors believe that providing further performance indicators for the Company itself would not enhance an understanding of the development, performance or position of the business of the Company.

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

Risk management

Risk is an inherent part of the Company's business activity. The Company 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 Company has developed its own risk management policy framework, which leverages the risk management policies and procedures of the Morgan Stanley Group, and which include escalation to the Company's Board of Directors and to appropriate senior management personnel.

Set out below is an overview of the Company's policies for the management of financial risk and other significant business risks. More detailed qualitative and quantitative disclosures about the Company's management of and exposure to financial risks are included in note 14 to the financial statements.

Market risk

Market risk refers to the risk of losses for a position or portfolio due to changes in rates, foreign exchange, equities, volatilities, correlations or other market factors.

Market risk management policies and procedures for the Company are consistent with those of the Morgan Stanley Group and include escalation to the Company's Board of Directors and appropriate senior management personnel.

The Company manages the market risk associated with its trading activities at both a trading division and an individual product level.

It is the policy and objective of the Company not to be exposed to market risk.

Credit risk

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations to the Company. Credit risk includes the risk that economic, social and political conditions and events in a foreign country will adversely affect an obligor's ability and willingness to fulfil their obligations.

Credit risk management policies and procedures for the Company are consistent with those of the Morgan Stanley Group and include escalation to the Company's Board of Directors and appropriate senior management personnel.

Credit risk exposure is managed on a global basis and in consideration of each significant legal entity within the Morgan Stanley Group. The credit risk management policies and procedures establish the framework for identifying, measuring, monitoring and controlling credit risk whilst ensuring transparency of material credit risks, ensuring compliance with established limits and escalating risk concentrations to appropriate senior management.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Country risk exposure

Country risk exposure is the risk that events in, or affecting, a foreign country might adversely affect the Company. "Foreign country" means any country other than the Cayman Islands. Sovereign risk, by contrast, is the risk that a government will be unwilling or unable to meet its debt obligations, or renege on the debt it guarantees. Sovereign risk is single-name risk for a sovereign government, its agencies and guaranteed entities.

Country risk exposure is measured in accordance with the Morgan Stanley Group's internal risk management standards and includes obligations from sovereign governments, corporations, clearing houses and financial institutions. The Morgan Stanley Group actively manages country risk exposure through a comprehensive risk management framework that combines credit and market fundamentals and allows the Morgan Stanley Group to effectively identify, monitor and limit country risk.

The Morgan Stanley Group's obligor credit evaluation process may also identify indirect exposures whereby an obligor has vulnerability or exposure to another country or jurisdiction. Examples of indirect exposures include mutual funds that invest in a single country, offshore companies whose assets reside in another country to that of the offshore jurisdiction and finance company subsidiaries of corporations. Indirect exposures identified through the credit evaluation process may result in a reclassification of country risk.

The Morgan Stanley Group conducts periodic stress testing that seeks to measure the impact on the Company's credit and market exposures of shocks stemming from negative economic or political scenarios. When deemed appropriate by the Morgan Stanley Group's risk managers, the stress test scenarios include possible contagion effects. The analysis, and the results of the stress tests, may result in the amendment of limits or exposure mitigation.

Liquidity risk

Liquidity risk refers to the risk that the Company will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity risk encompasses the Company's ability (or perceived ability) to meet its financial obligations without experiencing significant business disruptions or reputational damage that may threaten the Company's viability as a going concern. Liquidity risk also encompasses the associated funding risks triggered by the market or idiosyncratic stress events that may cause unexpected changes in funding needs or an inability to raise new funding.

The primary goal of the Morgan Stanley Group's liquidity risk management framework is to ensure that the Morgan Stanley Group, including the Company, have access to adequate funding across a wide range of market conditions and time horizons. The framework is designed to enable the Morgan Stanley Group to fulfil its financial obligations and support the execution of the Company's business strategies. The framework is further described in note 14.

The Company continues to actively manage its capital and liquidity position to ensure adequate resources are available to support its activities, to enable it to withstand market stresses.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Operational risk

Operational risk refers to the risk of loss, or of damage to the Company's reputation, resulting from inadequate or failed processes, people and systems or from external events (e.g. fraud, theft, legal and compliance risks, cyber attacks or damage to physical assets). Operational risk relates to the following risk event categories as defined by Basel Capital Standards: internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; business disruption and system failure; damage to physical assets; and execution, delivery and process management. Legal, regulatory and compliance risk is discussed below under "Legal, regulatory and compliance risk".

The Company may incur operational risk across the full scope of its business activities, including revenue-generating activities (e.g., sales and trading) and support and control groups (e.g., information technology and trade processing).

The Company has established an operational risk framework to identify measure, monitor and control risk across the Company. This framework is consistent with the framework established by the Morgan Stanley Group and includes escalation to the Company's Board of directors and appropriate senior management personnel. Effective operational risk management is essential to reducing the impact of operational risk incidents and mitigating legal and reputational risks. The framework is continually evolving to account for changes in the Company and to respond to the changing regulatory and business environment. The Company has implemented operational risk data and assessment systems to monitor and analyse internal and external operational risk events, to assess business environment and internal control factors and to perform scenario analysis. The collected data elements are incorporated in the operational risk capital model. The model encompasses both quantitative and qualitative elements. Internal loss data and scenario analysis results are direct inputs to the capital model, while external operational incidents, business environment and internal control factors are evaluated as part of the scenario analysis process.

In addition, the Company employs a variety of risk processes and mitigants to manage its operational risk exposures. These include a strong governance framework, a comprehensive risk management programme and insurance. Operational risks and associated risk exposures are assessed relative to the risk tolerance reviewed and confirmed by the Board and are prioritised accordingly. The breadth and range of operational risk are such that the types of mitigating activities are wide-ranging. Examples of activities include enhancement of defences against cyber attacks; use of legal agreements and contracts to transfer and/or limit operational risk exposures; due diligence; implementation of enhanced policies and procedures; exception management processing controls; and segregation of duties.

Primary responsibility for the management of operational risk is with the business, the control groups and the business managers therein. The business managers maintain processes and controls designed to identify, assess, manage, mitigate and report operational risk. Each of the business segments has a designated operational risk coordinator. The operational risk coordinator regularly reviews operational risk issues and reports to the Company's senior management within each business. Each control group also has a designated operational risk coordinator and a forum for discussing operational risk matters with the Company's senior management. Oversight of operational risk is provided by the Operational Risk Oversight Committee, regional risk committees and senior management. In the event of a merger; joint venture; divestiture; reorganisation; or creation of a new legal entity, a new product or a business activity, operational risks are considered, and any necessary changes in processes or controls are implemented.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Operational risk (continued)

The Operational Risk Department provides oversight of operational risk management and independently assesses measures and monitors operational risk. The Operational Risk Department works with the business divisions and control groups to help ensure a transparent, consistent and comprehensive framework for managing operational risk within each area and across the Company. The Operational Risk Department scope includes oversight of the technology and data risk management programme (e.g., cybersecurity), fraud risk management and prevention programme and a supplier management (vendor risk oversight and assessment) programme. Furthermore, the Operational Risk Department supports the collection and reporting of operational risk incidents and the execution of operational risk assessments; provides the infrastructure needed for risk measurement and risk management; and ensures ongoing validation and verification of the Company's advanced measurement approach for operational risk capital.

Business Continuity Management is responsible for identifying key risks and threats to the Company's resiliency and planning to ensure that a recovery strategy and required resources are in place for the resumption of critical business functions following a disaster or other business interruption. Disaster recovery plans are in place for critical facilities and resources, and redundancies are built into the systems as deemed appropriate. The key components of the Company's Business Continuity Management Programme include: crisis management; business recovery plans; applications/data recovery; work area recovery; and other elements addressing management, analysis, training and testing.

The Company maintains a programme that oversees our cyber and information security risks. Our cybersecurity and information security policies, procedures and technologies are designed to protect the Company's client and employee data against unauthorised disclosure, modification or misuse and are also designed to address regulatory requirements. These policies and procedures cover a broad range of areas, including: identification of internal and external threats, access control, data security, protective controls, detection of malicious or unauthorized activity, incident response, and recovery planning.

In connection with its ongoing operations, the Company utilises the services of external vendors, which it anticipates will continue and may increase in the future. These services include, for example, outsourced processing and support functions and consulting and other professional services. The Company manages its exposures to these services through a variety of means such as the performance of due diligence, consideration of operational risk, implementation of service level and other contractual agreements, and ongoing monitoring of the vendors' performance. The Company maintains a supplier risk management programme with policies, procedures, organisation, governance and supporting technology that aligns with our risk tolerance and is designed to meet regulatory requirements. The programme includes the adoption of appropriate risk management controls, including, but not limited to information security, operational failure, financial stability, disaster recoverability, reputational risk, safeguards against corruption and termination.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Legal, regulatory and compliance risk

Legal, regulatory and compliance risk includes the risk of legal or regulatory sanctions, material financial loss; including fines, penalties, judgements, damages and/ or settlements or loss to reputation the Company may suffer as a result of a failure to comply with laws, regulations, rules, related self-regulatory organisation standards and codes of conduct applicable to our business activities. This risk also includes contractual and commercial risk, such as the risk that a counterparty's performance obligations will be unenforceable. It also includes compliance with Anti-Money Laundering, anti-corruption and terrorist financing rules and regulations. The Company is generally subject to extensive regulation in the different jurisdictions in which it conducts its business.

The Company, principally through the Morgan Stanley Group's Legal and Compliance Division, has established procedures based on legal and regulatory requirements on a worldwide basis that are designed to facilitate compliance with applicable statutory and regulatory requirements and to require that the Company's policies relating to business conduct, ethics and practices are followed globally.

In addition, the Company 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 heightened legal and regulatory focus on the financial services and banking industries globally presents a continuing business challenge for the Company.

Going Concern

Retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Company's strategy. Additionally, the Company has access to further Morgan Stanley Group capital and liquidity as required.

Taking the above 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.

Approved by the Board and signed on its behalf by



Director

26 April 2018

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

DIRECTORS REPORT

The Directors present their report and financial statements (which comprise the statement of comprehensive income, the statement of changes in equity, the statement of financial position, the statement of cashflows and the related notes, 1 to 18) for the Company for the year ended 31 December 2017.

RESULTS AND DIVIDENDS

The result for the year, after tax, was \$nil (2016: \$nil).

During the year, no dividends were paid or proposed (2016: \$nil).

RISK MANAGEMENT AND FUTURE DEVELOPMENTS

Information regarding risk management and future developments has been included in the Strategic report.

DIRECTORS

The following Directors held office throughout the year and to the date of approval of this report:

A Gelfand
H Nakajima

DIRECTORS' LIABILITY INSURANCE

Directors' 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.

DIRECTORS' INDEMNITY

Qualifying third party indemnity provisions (as defined in section 234 of the Companies Act 2016 "Companies Act 2006") were in force during the year and up to and including the date of the Directors' report for the benefit of the Directors of the Company.

EVENTS AFTER THE REPORTING DATE

There have been no significant events since the reporting date.

AUDITOR

Deloitte LLP have expressed their willingness to continue in office as auditor of the Company and, under sections 485 to 488 of the Companies Act 2006, will be deemed to be re-appointed.

Statement as to disclosure of information to the auditor

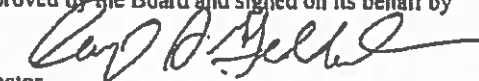
Each of the persons who are Directors of the Company at the date when this report is approved confirms that:

- so far as each of the Directors is aware, there is no relevant audit information (being information needed by the Company's auditor in connection with preparing their report) of which the Company's auditor is 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 Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

Approved by the Board and signed on its behalf by

Director



26 April 2018

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

DIRECTORS' RESPONSIBILITIES STATEMENT

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

The Company was incorporated as an exempt company under the laws of the Cayman Islands. The Directors and the shareholders of the Company require the financial statements of the Company to be prepared in accordance with Part 15 of the Companies Act 2006 of the UK (that would have applied had these been statutory accounts under the Companies Act 2006) and drawn up in US dollars.

UK Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have elected to prepare the financial statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the EU and Article 4 of the international Accounting Standards ("IAS") Regulation. Under UK company law the Directors must not approve the financial statements 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 these financial statements, the Directors are required by IAS 'Presentation of financial statements' ("IAS 1") to:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- 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
- make an assessment of the Company's ability to continue as a going concern.

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.

Furthermore, as the Company is an issuer whose securities are admitted to trading on the Luxembourg stock exchange, which is a regulated market, the Company must comply, amongst others, with Article 3(2) (c) of the Luxembourg law of 11 January 2008, as amended, in relation to certain transparency requirements (the "Transparency Law").

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

- the financial statements have been prepared in accordance with IFRSs as issued by the International Accounting Standards Board ("IASB") and as endorsed by the EU, and give a true and fair view of the assets, liabilities, financial position and result of the Company; and
- the management report represented by the Directors' report includes a fair review of the development and performance of the business and the position of the Company together with a description of the principal risks and uncertainties that the Company faces.

Approved by the Board and signed on its behalf by

Director

26 April 2018

To the Board of Directors

Morgan Stanley Capital (Cayman Islands) Limited

REPORT OF THE REVISEUR D'ENTREPRISES AGREE

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of Morgan Stanley Capital (Cayman Islands) Limited (the "Company"), which comprise the statement of financial position as at December 31, 2017, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2017, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with the EU Regulation N° 537/2014, the Law of 23 July 2016 on the audit profession (Law of 23 July 2016) and with International Standards on Auditing (ISAs) as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier" (CSSF). Our responsibilities under those Regulation, Law and standards are further described in the "Responsibilities of the "Réviseur d'Entreprises Agréé" for the Audit of the Financial Statements" section of our report. We are also independent of the Company in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) as adopted for Luxembourg by the CSSF together with the ethical requirements that are relevant to our audit of the financial statements, and have fulfilled our other ethical responsibilities under those ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of the audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Valuation of Level II Financial Instruments	
Relevant references in the financial statements	Note 3.c, 3.d, 9 and 15 to the Financial Statements
Key audit matter description	<p>The Company issues OPALS, which are securities whose investment performance corresponds generally to that of a benchmark index by an indirect investment in a basket of shares. The fair value of OPALS is determined using valuation models, incorporating observable inputs referencing identical or comparable securities to the underlying shares. The impact of own credit spreads is also considered and included as appropriate. OPALS are categorised as Level 2 in the fair value hierarchy.</p> <p>ELOs are purchased to hedge the issuance of OPALS. The investment performance of the ELOs corresponds generally to that of the same benchmark index by an indirect investment in a basket of shares, as that of the OPALS they were purchased to hedge. The fair value of the ELOs is determined using valuation models, incorporating observable inputs referencing identical or comparable securities to the underlying shares. The impact of own credit spreads is also considered and included as appropriate. ELOs are categorised as Level 2 in the fair value hierarchy.</p> <p>The valuations of Level 2 financial instruments are material and are the most significant part of the investment portfolio.</p> <p>As of 31 December 2017, the Company held USD 1,544,277 thousand OPALS and USD 1,544,277 thousand ELOs classified as Level 2 in the fair value hierarchy. The size of the portfolio of OPALS and ELOs and complexity of valuation models used to identify their fair values, as well as the use of inputs make these a key audit matter for the audit.</p>
How the scope of our audit responded to the key audit matter	<p>To address the complexities associated with auditing the value of Level 2 financial instruments, our team included valuation specialists having significant quantitative and modelling expertise to assist in performing our audit procedures. Our valuation audit procedures included the following control and substantive procedures:</p> <ul style="list-style-type: none"> • We tested the design and operating effectiveness of Morgan Stanley's valuation controls including the: <ul style="list-style-type: none"> ✓ Model certification control, which is designed to review a model's theoretical soundness and the appropriateness of its valuation methodology, including whether any limitations or valuation adjustments should be placed on a model's implementation or use given subjectivities in calibrating to varying market conditions. ✓ Independent Price Verification control, which is designed to review the appropriateness of valuation methodologies to derive model inputs which are not observable and are significant to the financial instrument's valuation, and ✓ The Company's daily trading profit and loss analysis, as well as its trade confirmation, and collateral dispute resolution controls. • Our substantive test procedures included: <ul style="list-style-type: none"> ✓ For a sample of Level 2 financial instruments, we checked the input data to determine if these were in line with the Management's input. ✓ We also evaluated the reasonableness of the valuation methodologies and models used by management.
Key observations	None

Other information

The Board of Directors is responsible for the other information. The other information comprises the information stated in the Directors' report and the Corporate Governance Statement but does not include the financial statements and our report of the "Réviseur d'Entreprises Agréé" thereon.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report this fact. We have nothing to report in this regard.

Responsibilities of the Board of Directors

The Board of Directors is responsible for the preparation and fair presentation of these financial statements in accordance with IFRSs as adopted by the European Union, and for such internal control as the Board of Directors determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Board of Directors is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Board of Directors either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Responsibilities of the "Réviseur d'Entreprises Agréé" for the Audit of the Financial Statements

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue a report of the "Réviseur d'Entreprises Agréé" that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the EU Regulation N° 537/2014, the Law of 23 July 2016 and with ISAs as adopted for Luxembourg by the CSSF will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with the EU Regulation N° 537/2014, the Law of 23 July 2016 and with ISAs as adopted for Luxembourg by the CSSF, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Board of Directors.
- Conclude on the appropriateness of Board of Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our report of the "Réviseur d'Entreprises Agréé" to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our report of the "Réviseur d'Entreprises Agréé". However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our report unless law or regulation precludes public disclosure about the matter.

Report on Other Legal and Regulatory Requirements

We have been appointed as "Réviseur d'Entreprises Agréé" by the General Meeting of the Shareholders and the duration of our uninterrupted engagement, including previous renewals and reappointments, is one year.

The Directors' report is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

The accompanying Corporate Governance Statement is presented on pages one to six. The information required by Article 68ter paragraph (1) letters c) and d) of the law of 19 December 2002 on the commercial and companies register and on the accounting records and annual accounts of undertakings, as amended, is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

We confirm that the prohibited non-audit services referred to in the EU Regulation N° 537/2014, on the audit profession were not provided and that we remain independent of the Company in conducting the audit.

Where neither disclosed in the management report nor in the financial statements, disclose here any services, in addition to the statutory audit, that were provided to the Company and its controlled undertakings.

Other matter

The Corporate Governance Statement includes, when applicable, information required by Article 68ter paragraph (1) points a), b), e), f) and g) of the law of 19 December 2002 on the commercial and companies register and on the accounting records and annual accounts of undertakings, as amended.

For Deloitte Audit, *Cabinet de Révision Agréé*



Ekaterina Volotovskaya, *Réviseur d'Entreprises Agréé*
Partner

April 26, 2018

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED**STATEMENT OF COMPREHENSIVE INCOME****Year ended 31 December 2017**

	Note	2017 \$'000	2016 \$'000
Net gains on financial instruments designated at fair value through profit or loss		-	-
Interest income	4,17	78	68
Interest expense	4,17	(82)	(68)
Other income	5	4	-
RESULT BEFORE INCOME TAX		<hr/>	<hr/>
Income tax		-	-
RESULT AND TOTAL COMPREHENSIVE INCOME FOR THE YEAR		<hr/> <hr/>	<hr/> <hr/>

All operations were continuing in the current and prior year

The notes on pages 18 to 41 form an integral part of the financial statements.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STATEMENT OF CHANGES IN EQUITY

Year ended 31 December 2017

	Share capital \$'000	Retained earnings \$'000	Total equity \$'000
Balance at 1 January 2016	1	-	1
Result and total comprehensive income for the year	-	-	-
Balance at 31 December 2016	1	-	1
Result and total comprehensive income for the year	-	-	-
Balance at 31 December 2017	1	-	1

The notes on pages 18 to 41 form an integral part of the financial statements.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED*Registered number: 43542***STATEMENT OF FINANCIAL POSITION****As at 31 December 2017**

	Note	2017 S'000	2016 S'000
ASSETS			
Loans and receivables:			
Other receivables	8	123	3,211
Financial assets designated at fair value through profit or loss	9,14	1,544,277	2,764,433
TOTAL ASSETS		<u>1,544,400</u>	<u>2,767,644</u>
LIABILITIES AND EQUITY			
Financial liabilities at amortised cost:			
Other payables	10	122	3,210
Financial liabilities designated at fair value through profit or loss	9,14	1,544,277	2,764,433
TOTAL LIABILITIES		<u>1,544,399</u>	<u>2,767,643</u>
EQUITY			
Share capital	11	1	1
Retained earnings		-	-
Equity attributable to owners of the Company		<u>1</u>	<u>1</u>
TOTAL EQUITY		<u>1</u>	<u>1</u>
TOTAL LIABILITIES AND EQUITY		<u>1,544,400</u>	<u>2,767,644</u>

These financial statements were approved by the Board and authorised for issue on

26 April 2018

Signed on behalf of the Board

Director

The notes on pages 18 to 41 form an integral part of the financial statements.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

STATEMENT OF CASH FLOWS

As at 31 December 2017

	2017	2016
	\$'000	\$'000
OPERATING ACTIVITIES		
Result for the year	-	-
<i>Adjustments for:</i>		
Interest income	(78)	(68)
Interest expense	82	68
Operating cash flows before changes in operating assets and liabilities	<u>4</u>	<u>-</u>
Changes in operating assets		
Decrease/(increase) in loans and receivables	3,166	(4)
Decrease/(increase) in financial assets designated at fair value through	1,220,156	(1,632,438)
	<u>1,223,322</u>	<u>(1,632,442)</u>
Changes in operating liabilities		
(Decrease)/increase in financial liabilities at amortised cost	(3,170)	4
(Decrease)/increase in financial assets designated at fair value through	(1,220,156)	1,632,438
	<u>(1,223,326)</u>	<u>1,632,442</u>
NET CASH FLOWS FROM OPERATING ACTIVITIES	<u>-</u>	<u>-</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	-	-
CASH AND CASH EQUIVALENTS AT THE BEGINNING	-	-
OF THE YEAR		
CASH AND CASH EQUIVALENTS AT THE END OF THE	<u>-</u>	<u>-</u>
YEAR		

The notes on pages 18 to 41 form an integral part of the financial statements.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

1. CORPORATE INFORMATION

The Company is incorporated and domiciled in the Cayman Islands, at the following address:

Maples Corporate Services Limited, PO Box 309, Ugland House, Grand Cayman, KY1-1104, Cayman Islands.

The Company is engaged in the issuance of OPALS and the hedging of obligations pursuant to such issuances.

The parent and ultimate controlling entity is disclosed in note 18 to the financial statements.

2. BASIS OF PREPARATION

Statement of compliance

The Company has prepared its annual financial statements in accordance with IFRSs issued by the International Accounting Standards Board ("IASB") as adopted by the EU, Interpretations issued by the IFRS Interpretations Committee ("IFRIC") and Part 15 of the Companies Act 2006.

New standards and interpretations adopted during the year

There were no standards or interpretations relevant to the Company's operations which were adopted during the year.

New standards and interpretations not yet adopted

At the date of authorisation of these financial statements, the following standards, amendments to standards and interpretations relevant to the Company's operations were issued by the IASB but not mandatory for annual periods beginning 1 January 2017. Except where otherwise stated, the Company does not expect that the adoption of the following standards, amendments to standards and interpretations will have a material impact on the Company's financial statements.

IFRS 9 '*Financial instruments*' ("IFRS 9") was issued by the IASB in November 2009, reissued in October 2010, amended in November 2013, and revised and reissued by the IASB in July 2014. IFRS 9 is applicable retrospectively, except where otherwise prescribed by transitional provisions of the standard, and is effective for annual periods beginning on or after 1 January 2018. The standard was endorsed by the EU in November 2016.

The main aspects of IFRS 9 which impact the Company are its requirements relating to:

- **Classification and measurement of financial assets**
The classification and measurement of financial assets is determined based upon how these financial assets are managed and their contractual cash flow characteristics. Measurement will be either at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss ('FVPL').
- **Impairment of financial assets**
The impairment requirements are based on expected credit losses and apply to financial assets measured at amortised cost and FVOCI, and certain loan commitments and financial guarantee contracts.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

2. BASIS OF PREPARATION (continued)

New standards and interpretations not yet adopted (continued)

The Morgan Stanley Group has undertaken a project to implement IFRS 9. As part of this project the Company has completed an evaluation of its business models and a review of the contractual terms of financial assets.

As a result of this evaluation, no financial assets or financial liabilities will change classification.

The Company has also completed its implementation of a revised approach for asset impairment, recording an expected credit loss ("ECL") allowance for all financial instruments not held at FVPL. The impact of the implementation of the expected credit loss impairment approach on retained earnings as at 1 January 2018 is not material to the Company.

Under the transitional provisions of the Standard, the Company will update the presentation of its primary statements on transition to IFRS 9 and the comparative period will be represented to align to the new format in the annual accounts.

Basis of measurement

The financial statements of the Company are prepared under the historical cost basis, except for certain financial instruments that have been measured at fair value as explained in the accounting policies below.

Critical judgements in applying the Company's accounting policies

No judgements have been made in the process of applying the Company's accounting policies that have had a significant effect on the amounts recognised in the financial statements.

The going concern assumption

The Company's business activities, together with the factors likely to affect its future development, performance and position, are reflected in the Business Review section of the Strategic report on pages 1 to 6. In addition, the notes to the financial statements include the Company'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.

The going concern assumption (continued)

As set out in the Strategic report, retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Company's strategy.

Taking the above 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.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. 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, Strategic and Directors' report are rounded to the nearest thousand 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 reporting date. Transactions and non-monetary assets and liabilities denominated in currencies other than US dollars are recorded at the rates prevailing at the dates of the transactions. All translation differences are taken through the statement of comprehensive income. Exchange differences recognised in the statement of comprehensive income are presented in 'Other income' or 'Other expense', except where noted in 3(c) below.

c. Financial instruments

The Company classifies its financial assets into the following categories on initial recognition: financial assets designated at fair value through profit or loss and loans and receivables.

The Company classifies its financial liabilities into the following categories on initial recognition: 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 designated at fair value through profit or loss

The Company has designated certain financial instruments at fair value through profit or loss when the financial instrument 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 through profit or loss 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 in the statement of financial position. 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 statement of comprehensive income in 'Net gains 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 statement of comprehensive income in 'Other expense'.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS Year ended 31 December 2017

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

ii) Loans and receivables and financial liabilities at amortised cost

Financial assets classified as loans and receivables are recognised when the Company becomes a party to the contractual provisions of the instrument. They are initially measured at fair value (see note 3(d) below) and subsequently measured at amortised cost less allowance for impairment. Interest is recognised in the statement of comprehensive income 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 statement of comprehensive income in 'Other expense'.

Financial assets classified as loans and receivables include other receivables.

Financial liabilities at amortised cost are recognised when the Company becomes a party to the contractual provisions of the instrument. They are initially measured at fair value (see note 3(d) below) and subsequently measured at amortised cost. Interest is recognised in the statement of comprehensive income 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 instrument (or a group of financial instruments) and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial instrument (or, where appropriate a shorter period) to the carrying amount of the financial instrument. The effective interest rate is established on initial recognition of the financial instrument.

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 instrument.

d. Fair value

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.

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, assumptions are set to reflect those that the Company believes market participants would use in pricing the asset or liability at the measurement date.

Where the Company manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the Company measures the fair value of that group of financial instruments consistently with how market participants would price the net risk exposure at the measurement date.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Fair value measurement (continued)

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 that were developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect assumptions the Company believes other market participants would use in pricing the asset or liability, that are developed based on the best information available in the circumstances.

The hierarchy is broken down into three levels based on the observability of inputs as follows, with Level 1 being the highest and Level 3 being the lowest level:

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

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, for example, the type of product, whether the product is new and not yet established in the marketplace, the liquidity of markets and other characteristics particular to the product. 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. Accordingly, the degree of judgement exercised by the Company in determining fair value is greatest for instruments categorised in Level 3 of the fair value hierarchy.

The Company considers prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or from Level 2 to Level 3 of the fair value hierarchy.

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

For assets and liabilities that are transferred between levels in the fair value hierarchy during the period, fair values are ascribed as if the assets or liabilities had been transferred as of the beginning of the period.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Valuation techniques (continued)

Many cash instruments and OTC derivative contracts have bid and ask prices that can be observed in the marketplace. Bid prices reflect the highest price that a party is willing to pay for an asset. Ask prices represent the lowest price that a party is willing to accept for an asset. The Company carries positions at the point within the bid-ask range that meets its best estimate of fair value. For offsetting positions in the same financial instrument, the same price within the bid-ask spread is used to measure both the long and short positions.

Fair value for many cash instruments and OTC derivative contracts is derived using pricing models. Pricing models take into account the contract terms, as well as multiple inputs including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, creditworthiness of the Company, option volatility and currency rates.

Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk.

Adjustments for liquidity risk adjust model-derived mid-market levels of Level 2 and Level 3 financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trade activity, broker quotes or other external third-party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions.

The Company considers the impact of changes in own credit spreads based upon observations of the secondary bond market spreads when measuring the fair value for short-term and long-term borrowings. For OTC derivatives, the impact of changes in both the Company's and the counterparty's credit rating 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 its exposure to each counterparty.

Adjustments for model uncertainty are taken for positions whose underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible.

The Company 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 judgement is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Valuation process

The Valuation Review Group ("VRG") within the Financial Control Group ("FCG") is responsible for the Company's fair value valuation policies, processes and procedures. VRG is independent of the business units and reports to the Chief Financial Officer of the Morgan Stanley Group ("CFO"), who has final authority over the valuation of the Company's financial instruments. VRG implements valuation control processes designed to validate the fair value of the Company's financial instruments measured at fair value including those derived from pricing models.

Model Review. VRG, in conjunction with the Model Risk Management Department, ("MRM") which reports to the Chief Risk Officer of the Morgan Stanley Group ("CRO"), independently reviews valuation models' theoretical soundness, the appropriateness of the valuation methodology and calibration techniques developed by the business units using observable inputs. Where inputs are not observable, VRG reviews the appropriateness of the proposed valuation methodology to determine that it is consistent with how a market participant would arrive at the unobservable input. The valuation methodologies utilised in the absence of observable inputs may include extrapolation techniques and the use of comparable observable inputs. As part of the review, VRG develops a methodology to independently verify the fair value generated by the business unit's valuation models. The Company generally subjects valuations and models to a review process initially and on a periodic basis thereafter.

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

The results of this independent price verification and any adjustments made by VRG to the fair value generated by the business units are presented to management of the Morgan Stanley Group's three business segments (i.e. Institutional Securities, Wealth Management and Investment Management), the CFO and the CRO on a regular basis.

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

VRG reviews the models and valuation methodology used to price new material Level 2 and Level 3 transactions and both FCG and MRM must approve the fair value of the trade that is initially recognised.

Level 3 Transactions. VRG reviews the business unit's valuation techniques to assess whether these are consistent with market participant assumptions.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

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 the use of 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 statement of comprehensive income and is recognised instead when the market data becomes observable.

e. Derecognition of financial assets and liabilities

The Company derecognises a financial asset when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risk and rewards of ownership of the asset.

If the asset has been transferred, and the entity neither transfers nor retains substantially all of the risks and rewards of the asset, then the entity determines whether it has retained control of the asset.

If the entity has retained control of the asset, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset. If the entity has not retained control of the asset, it derecognises the asset and separately recognises any rights or obligation created or retained in the transfer.

The Company derecognises financial liabilities when the Company's obligations are discharged, cancelled or they expire.

f. 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 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 loans and receivables are measured as the difference between the carrying amount of the loans and receivables and the present value of estimated cash flows discounted at the asset's original effective interest rate. Such impairment losses are recognised in the statement of comprehensive income within 'Other expense' and are recognised against the carrying amount of the impaired asset on the 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.

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) (ii). 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.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

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' and foreign exchange differences disclosed in 'Other income' (note 5), within the statement of comprehensive income.

No other gains or losses have been recognised in respect of financial liabilities at amortised cost other than as disclosed as 'Interest expense' and foreign exchange differences disclosed in 'Other income' (note 5), within the statement of comprehensive income.

5. OTHER INCOME

	2017 \$'000	2016 \$'000
Net foreign exchange gains	<u>4</u>	<u>-</u>

6. AUDIT FEES

Audit fees of \$60,000 (2016: \$50,000) have been borne by another Morgan Stanley Group undertaking in both the current and prior year.

7. INCOME TAX

The Company has been granted exempt status in the Cayman Islands. A 20 year tax exemption certificate was issued in 2012.

8. OTHER RECEIVABLES

	2017 \$'000	2016 \$'000
Amounts due from other Morgan Stanley Group undertakings	<u>123</u>	<u>3,211</u>

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

9. 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:

OPALS – These instruments are securities whose investment performance corresponds generally to that of a benchmark index by an indirect investment in a basket of shares. All dividends and certain other amounts associated with these baskets, net of certain expenses, are received by the Company to enable it to fulfil its obligations to holders of OPALS.

These instruments contain an embedded derivative which significantly modifies the cash flows of the issuance. The return on the instrument is linked to an underlying that is not clearly and closely related to the debt host including, but not limited to, equity, credit or commodity linked notes. Using the fair value option, the entire instrument is measured at fair value through profit or loss.

ELOs – The Company is a party to a Master Equity Linked Obligation Agreement and to a Master Equity Linked Counterparty Agreement with other Morgan Stanley Group undertakings. ELOs are purchased to hedge the issuance of OPALS and track the value of a basket of equities. These instruments contain an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract. Using the fair value option, the entire instrument is measured at fair value through profit or loss.

	2017		2016	
	Assets \$'000	Liabilities \$'000	Assets \$'000	Liabilities \$'000
OPALS	-	1,544,277	-	2,764,433
ELOs	1,544,277	-	2,764,433	-
	<u>1,544,277</u>	<u>1,544,277</u>	<u>2,764,433</u>	<u>2,764,433</u>

There were no significant gains or losses attributable to changes in own credit risk for financial liabilities designated at fair value for year ended 31 December 2017 (2016:\$nil).

The Company determines the amount of changes in fair value attributable to changes in counterparty credit risk or own credit risk, as relating to loans and receivables and financial liabilities designated at fair value, by first determining the fair value including the impact of counterparty credit risk or own credit risk, and then deducting those changes in fair value representing managed market risk. In determining fair value, the Company considers the impact of changes in own credit spreads based upon observations of the secondary band market spreads when measuring the fair value for issued structured notes. The Company considers that this approach most faithfully represents the amount of change in fair value due to both counterparty credit risk and the Company's own credit risk.

The carrying amount of financial liabilities designated at fair value at 31 December 2017 and 31 December 2016 is considered to be a reasonable approximation of the contractual value at maturity.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

10. OTHER PAYABLES

	2017 \$'000	2016 \$'000
Amounts due to other Morgan Stanley Group undertakings	<u>122</u>	<u>3,210</u>

11. EQUITY

Ordinary share capital

	Ordinary shares of \$1 each Number
Authorised	
At 1 January 2016, 31 December 2016 and 31 December 2017	<u>500,000</u>

	Ordinary shares of \$1 each Number	Ordinary shares of \$1 each \$'000
Issued and fully paid		
At 1 January 2016, 31 December 2016 and 31 December 2017	<u>1,000</u>	<u>1</u>

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled, on a show of hands, to one vote and, on a poll, one vote per share at meetings of the shareholders of the Company.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

12. EXPECTED MATURITY OF 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.

At 31 December 2017

	Less than or equal to twelve months \$'000s	More than twelve months \$'000s	Total \$'000s
ASSETS			
Loans and receivables:			
Other receivables	62	61	123
Financial assets designated at fair value through profit or loss	-	1,544,277	1,544,277
	<u>62</u>	<u>1,544,338</u>	<u>1,544,400</u>
LIABILITIES			
Financial liabilities at amortised cost:			
Other payables	118	4	122
Financial assets designated at fair value through profit or loss	-	1,544,277	1,544,277
	<u>118</u>	<u>1,544,281</u>	<u>1,544,399</u>

At 31 December 2016

	Less than or equal to twelve months \$'000s	More than twelve months \$'000s	Total \$'000s
ASSETS			
Loans and receivables:			
Other receivables	3,211	-	3,211
Financial assets designated at fair value through profit or loss	-	2,764,433	2,764,433
	<u>3,211</u>	<u>2,764,433</u>	<u>2,767,644</u>
LIABILITIES			
Financial liabilities at amortised cost:			
Other payables	3,210	-	3,210
Financial assets designated at fair value through profit or loss	-	2,764,433	2,764,433
	<u>3,210</u>	<u>2,764,433</u>	<u>2,767,643</u>

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

13. SEGMENT REPORTING

Segment information is presented in respect of the Company's business and geographical segments. The business segments are based on the Company's management and internal reporting structure.

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 Company's own business segments are consistent with those of Morgan Stanley.

The Company has one reportable business segment, Institutional Securities, which provides financial services to financial institutions. The Company's business includes the issuance of financial instruments and the hedging of the obligations arising pursuant to such issuances.

Geographical segments

The Company operates in one geographical market, Europe, Middle East and Africa.

14. FINANCIAL RISK MANAGEMENT

Risk management procedures

Risk is an inherent part of the Company's business activity. The Company 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 Company has developed its own risk management policy framework, which is consistent with and leverages the risk management policies and procedures of the Morgan Stanley Group and which include escalation to the Company's Board of Directors and to appropriate senior management personnel.

The principal activity of the Company is the issuance of OPALS and the hedging of the obligations arising pursuant to such issuances. It is the policy and objective of the Company not to be exposed to market risk. On issuance of each financial instrument, the Company enters into economics hedges of its obligations by purchasing financial instruments from another Morgan Stanley Group undertaking.

Significant risks faced by the Company resulting from its trading activities are set out below.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

14. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations to the Company. The Company primarily incurs credit risk to institutions and sophisticated investors through its Institutional Securities business segments.

Credit risk exposure is managed on a global basis and in consideration of each significant legal entity within the Morgan Stanley Group. The credit risk management policies and procedures establish the framework for identifying, measuring, monitoring and controlling credit risk whilst ensuring transparency of material credit risks, compliance with established limits and escalating risk concentrations to appropriate senior management.

The Company enters into all of its financial asset transactions with other Morgan Stanley Group undertakings, and both the Company and the other Morgan Stanley Group undertakings are wholly-owned subsidiaries of the same ultimate parent entity, Morgan Stanley. As a result of the implicit support that would be provided by Morgan Stanley, the Company is considered exposed to the credit risk of Morgan Stanley, except where the Company transacts with other Morgan Stanley Group undertakings that have a higher credit rating to that of Morgan Stanley.

The maximum exposure to credit risk of the Company at the reporting date is the carrying amount of the financial assets held in the statement of financial position. The Company has not entered into any credit enhancements to manage its exposure to credit risk.

The Company does not have any significant exposure arising from items not recognised on its statement of financial position

Exposure to credit risk by class

Class	Gross credit exposure (1)	
	2017 \$'000	2016 \$'000
Loans and receivables:		
Other receivables	123	3,211
Financial assets designated at fair value through profit and loss	<u>1,544,277</u>	<u>2,764,433</u>
	<u>1,544,400</u>	<u>2,767,644</u>

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

Maximum exposure to credit risk by credit rating⁽¹⁾

Credit rating	Gross credit exposure	
	2017 \$'000	2016 \$'000
A	<u>1,544,400</u>	<u>2,767,644</u>

(1) All credit ratings obtained from external rating agencies.

At 31 December 2017, there were no financial assets past due but not impaired or individually impaired (2016: \$nil).

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

14. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk

Liquidity risk refers to the risk that the Company will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity risk encompasses the Company's ability (or perceived ability) to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten the Company's viability as a going concern. Liquidity risk also encompasses the associated funding risks triggered by the market or idiosyncratic stress events that may cause unexpected changes in funding needs or an inability to raise new funding. Generally, the Company incurs liquidity risk as a result of its trading, lending, investing and client facilitation activities.

The Morgan Stanley Group's Liquidity Risk Management Framework is critical to helping ensure that the Company maintains sufficient liquidity reserves and durable funding sources to meet its daily obligations and to withstand unanticipated stress events. The Liquidity Risk Department is a distinct area in Risk Management, which oversees and monitors liquidity risk. The Liquidity Risk Department ensures transparency of material liquidity risks, compliance with established risk limits and escalation of risk concentrations to appropriate senior management. To execute these responsibilities, the Liquidity Risk Department:

- Establishes limits in line with the Morgan Stanley Group's risk appetite;
- Identifies and analyses emerging liquidity risks to ensure such risks are appropriately mitigated;
- Monitors and reports risk exposures against metrics and limits, and;
- Reviews the methodologies and assumptions underpinning the Morgan Stanley Group's Liquidity Stress Tests to ensure sufficient liquidity and funding under a range of adverse scenarios.

The liquidity risks identified by these processes are summarised in reports produced by the Liquidity Risk Department that are circulated to and discussed with the EMEA Assets/ Liability Management Committee ("ALCO"), EMEA Risk Committee and the MSI Risk Committee, as appropriate.

The Treasury Department and applicable business units have primary responsibility for evaluating, monitoring and controlling the liquidity risks arising from the Morgan Stanley Group's business activities, and for maintaining processes and controls to manage the key risks inherent in their respective areas. The Liquidity Risk Department coordinates with the Treasury Department and these business units to help ensure a consistent and comprehensive framework for managing liquidity risk across the Morgan Stanley Group.

The Company's liquidity risk management policies and procedures are consistent with those of the Morgan Stanley Group.

The primary goal of the Company's liquidity risk and funding management framework is to ensure that the Company has access to adequate funding across a wide range of market conditions and time horizons. The framework is designed to enable the Company to fulfil its financial obligations and support the execution of its business strategies.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS Year ended 31 December 2017

14. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

The following principles guide the Company's liquidity risk management framework:

- Sufficient liquid assets should be maintained to cover maturing liabilities and other planned and contingent outflows;
- Maturity profile of assets and liabilities should be aligned, with limited reliance on short-term funding;
- Source, counterparty, currency, region, and term of funding should be diversified; and
- Liquidity Stress Tests should anticipate, and account for, periods of limited access to funding.

The Company hedges all of its financial liabilities with financial assets entered into with other Morgan Stanley Group undertakings, where both the Company and other Morgan Stanley Group undertakings are wholly-owned subsidiaries of the same parent, Morgan Stanley. Further, the maturity profile of the financial assets matches the maturity profile of the financial liabilities.

The core components of the Morgan Stanley Group's liquidity management framework, which includes consideration of the liquidity risk for each individual legal entity, are the Required Liquidity Framework, Liquidity Stress Tests and the Global Liquidity Reserve, which support the Morgan Stanley Group's target liquidity profile.

Required Liquidity Framework

The Required Liquidity Framework establishes the amount of liquidity the Company must hold in both normal and stressed environments to ensure that its financial condition and overall soundness is not adversely affected by an inability (or perceived inability) to meet its financial obligations in a timely manner. The Required Liquidity Framework considers the most constraining liquidity requirement to satisfy all regulatory and internal limits at a Morgan Stanley Group and legal entity level.

Liquidity Stress Tests

The Morgan Stanley Group uses Liquidity Stress Tests to model external and intercompany flows across multiple scenarios and a range of time horizons. These scenarios contain various combinations of idiosyncratic and systemic stress events of different severity and duration. The methodology, implementation, production and analysis of the Company's Liquidity Stress Tests are important components of the Required Liquidity Framework.

The Liquidity Stress Tests are produced for Morgan Stanley and its major operating subsidiaries, as well as at major currency levels, to capture specific cash requirements and cash availability at various legal entities. The Liquidity Stress Tests assume that subsidiaries will use their own liquidity first to fund their obligations before drawing liquidity from Morgan Stanley. It is also assumed that Morgan Stanley will support its subsidiaries and will not have access to cash that may be held at certain subsidiaries. In addition to the assumptions underpinning the Liquidity Stress Tests, Morgan Stanley Group takes into consideration the settlement risk related to intra-day settlement and clearing of securities and financial activities.

Since the Company hedges the liquidity risk of its financial liabilities with financial assets that match the maturity profile of the financial liabilities, the Company is not considered a major operating subsidiary for the purposes of liquidity risk. However, the Company would have access to the cash or liquidity reserves held by Morgan Stanley in the unlikely event that it was unable to access adequate financing to service its financial liabilities when they become payable.

The Required Liquidity Framework and Liquidity Stress Tests are evaluated on an ongoing basis and reported to the Firm Risk Committee, Asset/ Liability Management Committee, and other appropriate risk committees.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

14. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Global Liquidity Reserve

The Morgan Stanley Group maintains sufficient liquidity reserves ("the Global Liquidity Reserve") to cover daily funding needs and to meet strategic liquidity targets sized by the Required Liquidity Framework and Liquidity Stress Tests. The size of the Global Liquidity Reserve is actively managed by the Morgan Stanley Group considering the following components: unsecured debt maturity profile; balance sheet size and composition; funding needs in a stressed environment inclusive of contingent cash outflows and collateral requirements. In addition, the Morgan Stanley Group's Global Liquidity Reserve includes a discretionary surplus based on the Morgan Stanley Group's risk tolerance and is subject to change depending on market and firm-specific events.

The Morgan Stanley Group's Global Liquidity Reserve, to which the Company has access, is held within Morgan Stanley and its major operating subsidiaries and is composed of diversified cash and cash equivalents and unencumbered highly liquid securities.

Eligible unencumbered highly liquid securities include US government securities, US agency securities, US agency mortgage-backed securities, non-US government securities and other highly liquid investment grade securities.

The ability to monetise assets during a liquidity crisis is critical. The Morgan Stanley Group believes that the assets held in its Global Liquidity Reserve can be monetised within five business days in a stressed environment given the highly liquid and diversified nature of the reserves.

Funding management

The Morgan Stanley Group manages its funding in a manner that reduces the risk of disruption to the Morgan Stanley Group's and the Company's operations. The Morgan Stanley Group pursues a strategy of diversification of secured and unsecured funding sources (by product, investor and region) and attempts to ensure that the tenor of the Morgan Stanley Group's, and the Company's, liabilities equals or exceeds the expected holding period of the assets being financed.

The Morgan Stanley Group funds its balance sheet on a global basis through diverse sources, which includes consideration of the funding risk of each legal entity. These sources may include the Morgan Stanley Group's equity capital, long-term borrowing, securities sold under agreements to repurchase ("repurchase agreements"), securities lending, deposits, letters of credit and lines of credit. The Morgan Stanley Group has active financing programmes for both standard and structured products targeting global investors and currencies.

Balance sheet management

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

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

14. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Maturity analysis

In the following maturity analysis financial assets and financial liabilities designated at fair value through profit or loss are disclosed according to their earliest contractual maturity; all such amounts are presented at their fair value, consistent with how these financial instruments are managed. All other amounts represent undiscounted cash flows receivable and payable by the Company arising from its financial assets and financial liabilities to earliest contractual maturities as at 31 December 2017 and 31 December 2016. Receipts of financial assets and 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 Company to appropriately reflect the liquidity risk arising from these financial assets and financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial assets and financial liabilities is managed by the Company.

31 December 2017	On demand \$'000
Financial assets	
Loans and receivables:	
Other receivables	123
Financial assets designated at fair value through profit or loss: ELOs	1,544,277
Total financial assets	1,544,400
Financial liabilities	
Financial liabilities at amortised cost:	
Other payables	122
Financial liabilities designated at fair value through profit or loss: OPALS	1,544,277
Total financial liabilities	1,544,399
31 December 2016	On demand \$'000
Financial assets	
Loans and receivables:	
Other receivables	3,211
Financial assets designated at fair value through profit or loss: ELOs	2,764,433
Total financial assets	2,767,644
Financial liabilities	
Financial liabilities at amortised cost:	
Other payables	3,210
Financial liabilities designated at fair value through profit or loss: OPALS	2,764,433
Total financial liabilities	2,767,643

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NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

14. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk

Market risk is defined by IFRS 7 '*Financial instruments – Disclosures*' ("IFRS 7") as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.

The Company manages the market risk associated with its trading activities at both division and an individual product level, and includes consideration of market risk at the legal entity level.

Sound market risk management is an integral part of the Company's culture. The Company is responsible for ensuring that market risk exposures are well-managed and monitored. The Company also ensures transparency of material market risks, monitors compliance with established limits, and escalates 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 including monitoring Value-at-risk ("VaR") and stress testing analyses, routinely reports risk summaries and maintains the VaR and scenario analysis methodologies. The Company is managed within the Morgan Stanley Group's global framework. The market risk management policies and procedures of the Company include performing risk analyses and reporting any material risks identified to appropriate senior management of the Company.

The Company enters into all of its financial asset transactions with other Morgan Stanley Group undertakings, where both the Company and the other Morgan Stanley Group undertakings are wholly-owned subsidiaries of the same group parent entity, Morgan Stanley.

The issued OPALS expose the Company to the risk of changes in market prices of the underlying securities, interest rate risk and, where denominated in currencies other than US dollar, the risk of changes in rates of exchange between the US dollar and the other relevant currencies. The Company uses the risk mirroring contracts, in the form of ELOs, which it purchases from another Morgan Stanley Group undertaking, to match the price, interest rate and foreign currency risks associated with the issuance of the OPALS, consistent with the Company's risk management strategy. As such, the Company is not exposed to any market risk on these financial instruments.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

15. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE

a. Financial assets and liabilities recognised at fair value on a recurring basis

The following tables present the carrying value of the Company's financial assets and financial liabilities recognised at fair value on a recurring basis, classified according to the fair value hierarchy.

2017

	Quoted prices in active market (Level 1) \$'000	Valuation techniques using observable inputs (Level 2) \$'000	Valuation techniques with significant unobservable inputs (Level 3) \$'000	Total \$'000
Financial assets designated at fair value through profit or loss:				
- ELOs	-	1,544,277	-	1,544,277
Total financial assets measured at fair value	-	1,544,277	-	1,544,277

Financial liabilities designated at fair value through
profit or loss:

- OPALS	-	1,544,277	-	1,544,277
Total financial liabilities measured at fair value	-	1,544,277	-	1,544,277

2016

	Quoted prices in active market (Level 1) \$'000	Valuation techniques using observable inputs (Level 2) \$'000	Valuation techniques with significant unobservable inputs (Level 3) \$'000	Total \$'000
Financial assets designated at fair value through profit or loss:				
- ELOs	-	2,764,433	-	2,764,433
Total financial assets measured at fair value	-	2,764,433	-	2,764,433

Financial liabilities designated at fair value through
profit or loss:

- OPALS	-	2,764,433	-	2,764,433
Total financial liabilities measured at fair value	-	2,764,433	-	2,764,433

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

15. ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (CONTINUED)

a. Financial assets and liabilities recognised at fair value on a recurring basis (continued)

The Company's valuation approach and fair value hierarchy categorisation for certain significant classes of financial instruments recognised at fair value on a recurring basis is as follows:

OPALS

The Company issues OPALS, which are securities whose investment performance corresponds generally to that of a benchmark index by an indirect investment in a basket of shares. The fair value of OPALS is determined using valuation models, incorporating observable inputs referencing identical or comparable securities to the underlying shares. The impact of own credit spreads is also considered and included as appropriate. OPALS are categorised in Level 2 of the fair value hierarchy.

ELOs

ELOs are purchased to hedge the issuance of OPALS as the investment performance of the ELOs corresponds generally to that of the same benchmark index by an indirect investment in a basket of shares, as that of the OPALS they were purchased to hedge. The fair value of the ELOs is determined using valuation models, incorporating observable inputs referencing identical or comparable securities to the underlying shares. The impact of own credit spreads is also considered and included as appropriate. ELOs are categorised in Level 2 of the fair value hierarchy.

b. Transfers between Level 1 and Level 2 of the fair value hierarchy for financial assets and liabilities recognised at fair value on a recurring basis

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the current and prior year.

c. Changes in Level 3 financial assets and liabilities recognised at fair value on a recurring basis

There were no transfers between Level 2 and Level 3 of the fair value hierarchy during the current and prior year.

d. Assets and liabilities measured at fair value on a non-recurring basis

Non-recurring fair value measurements of assets and liabilities are those which are required or permitted in the statement of financial position in particular circumstances. There were no assets or liabilities measured at fair value on a non-recurring basis during the year or prior year.

16. ASSETS AND LIABILITIES NOT MEASURED AT FAIR VALUE

For all financial instruments not measured at fair value, the carrying amount is considered to be a reasonable approximation of fair value due to the short term nature of these assets and liabilities.

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

17. 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 required capital ("Required Capital") estimation is based on the Required Capital Framework, an internal capital adequacy measure. This framework is a risk-based and leverage use of capital measure, which is compared with the Morgan Stanley Group's regulatory capital to ensure that the Morgan Stanley Group maintains an amount of going concern capital after absorbing potential losses from stress events where applicable, at a point in time. The Morgan Stanley Group defines the difference between its total average common equity and the sum of the average common equity amounts allocated to our business segments as Parent Company equity. The Morgan Stanley Group generally hold Parent company equity for prospective regulatory requirements, organic growth, acquisition and other capital needs.

The Required Capital Framework is expected to evolve over time in response to changes in the business and regulatory environment and for example to incorporate changes in stress testing or enhancements in modelling techniques. The Morgan Stanley Group will continue to evaluate the framework with respect to the impact of future regulatory requirements, as appropriate.

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.

In order to maintain or adjust the capital structure as described above, the Company may adjust the amount of dividends paid, return capital to shareholders, issue new shares, or sell assets to reduce debt.

The Company manages the following items as capital:

	2017 \$'000	2016 \$'000
Ordinary share capital	<u>1</u>	<u>1</u>

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December 2017

18. RELATED PARTY DISCLOSURES

Parent and subsidiary relationships

Parent and ultimate controlling entity

The entire issued share capital of the Company is held under the terms of a trust established under Cayman Islands law with Deutsche Bank (Cayman) Limited.

In the Directors opinion, for accounting purposes, 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 the State of Delaware, the United States of America. Copies of its financial statements can be obtained from www.morganstanley.com/investorrelations.

Key management compensation

Key management personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Company. Key management personnel include the Board of Directors of Morgan Stanley Capital (Cayman Islands) Limited.

Key management personnel compensation in respect of their services rendered comprised the following:

	2017 \$'000	2016 \$'000
Short-term employee benefits	3	5

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

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 Company 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. Settlement of the outstanding balances will be made via inter-company mechanisms. The Company has not recognised any expense and has made no provision for impairment relating to the amount of outstanding balances from related parties (2016: \$nil).

Funding

The Company 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 statement of comprehensive income during the year are shown in the table below:

MORGAN STANLEY CAPITAL (CAYMAN ISLANDS) LIMITED

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18. RELATED PARTY DISCLOSURES (CONTINUED)

Transactions with related parties (continued)

General funding (continued)

	2017		2016	
	Interest \$'000	Balance \$'000	Interest \$'000	Balance \$'000
Amounts due from other Morgan Stanley Group undertakings	<u>78</u>	<u>123</u>	<u>68</u>	<u>3,211</u>
Amounts due to the Company's direct and indirect parent undertakings	4	50	1	46
Amounts due to other Morgan Stanley Group undertakings	<u>78</u>	<u>72</u>	<u>67</u>	<u>3,164</u>
	<u>82</u>	<u>122</u>	<u>68</u>	<u>3,210</u>

Trading and risk management

The Company issues OPALS and hedges the obligations arising from the issuance by entering into ELOs with another Morgan Stanley Group undertaking. All such transactions are entered into on an arm's length basis. These transactions may give rise to credit risk either for the Company, or to a related party towards the Company. The total amounts receivable and payable on OPALS and ELOs were as follows:

	2017 \$'000	2016 \$'000
Amounts due from other Morgan Stanley Group undertakings	<u>1,544,277</u>	<u>2,764,433</u>

Infrastructure services

In the current and prior year, the Company uses infrastructure services, including the provision of office facilities, operated by other Morgan Stanley Group undertakings at no charge. In addition, as disclosed in note 6, the audit fees have been borne by another Morgan Stanley Group undertaking.