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MORGAN STANLEY & CO. INTERNATIONAL plc

Report and financial statements

31 December 2013

MORGAN STANLEY & CO. INTERNATIONAL plc

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MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

The Directors present their Strategic report for Morgan Stanley & Co. International plc (the “Company”) and all of its subsidiary undertakings (together “the Group”) for the year ended 31 December 2013.

PRINCIPAL ACTIVITY

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions.

The Company operates branches in the Dubai International Financial Centre, France, Korea, the Netherlands, New Zealand, Poland, the Qatar Financial Centre and Switzerland. Details of the principal subsidiaries held directly and indirectly by the Company are disclosed in note 13.

There have not been any changes in the Group’s principal activity in the year under review other than on 1 January 2013, the financial advisory business conducted by another United Kingdom (“UK”) Morgan Stanley Group undertaking, Morgan Stanley & Co. Limited (“MSCL”), was contributed to the Group. This did not have a significant impact on the Group’s net profit after tax. Further details are provided within the business review section below.

On 12 December 2013, the Group’s immediate parent undertaking changed from Morgan Stanley UK Group to Morgan Stanley Investments (UK) as a result of Morgan Stanley UK Group contributing its holding in the Company to Morgan Stanley Investments (UK).

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

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

BUSINESS REVIEW

During 2013, global market and economic conditions showed improvement from 2012, though significant uncertainty remained. Investor sentiment was boosted by encouraging signs of improvement in the global economy during the second half of 2013. The US economy continued its moderate growth pace, but while as a whole the recession in the euro-area came to an end, significant pockets of slow or negative growth remained in Europe. Global market and economic conditions were also challenged by investor concerns about the US longer-term budget outlook and the scaling back of monetary stimulus, the remaining European sovereign debt issues and slowing economic growth in emerging markets. Shorter term concerns over the US budget standoff were resolved in late 2013 as Congress came to a tentative agreement on federal government funding for the next two fiscal years. Elsewhere, especially in parts of Europe, growth remains hindered by fiscal and longer term structural issues in the economy.

In Europe, major equity market indices finished higher at 31 December 2013 compared to 31 December 2012. Euro-area gross domestic product started to grow in the second quarter of 2013, and the European Central Bank (“ECB”) views this as a gradual recovery in economic conditions, albeit with significant downside risks. The euro-area unemployment rate increased to 12% at 31 December 2013 from 11.9% at 31 December 2012. At 31 December 2013, the Bank of England’s benchmark interest rate was 0.5%, which was unchanged from 31 December 2012. To stimulate economic activity in Europe, during 2013 the ECB lowered the benchmark interest rate from 0.75% to 0.25% and indicated that it will keep open its special liquidity facilities until at least the middle of 2014.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Overview of 2013 Financial Results

The consolidated income statement for the year is set out on page 17. The Group reported a profit after tax for the year of \$37 million, compared to a profit after tax of \$9 million for the year ended 31 December 2012.

Included in the current year is a loss on disposal of subsidiaries of \$151 million (2012: \$30 million) resulting from a reclassification from the "Currency translation reserve" to the consolidated income statement (see note 13). The subsidiaries disposed of were non-US dollar functional currency entities and were sold to another Morgan Stanley undertaking outside of the Group for consideration equal to their net book value. This reclassification did not have an impact on the net assets of the Group.

The Group's revenues are best reviewed across the aggregate of 'Net gains on financial instruments classified as held for trading', 'Net gains on financial instruments designated at fair value through profit or loss', 'Net gains on available-for-sale financial assets', 'Interest income', 'Interest expense' and 'Other income' ("aggregate revenues"). Aggregate revenues for the year increased by 15% to \$4,232 million compared to \$3,674 million in 2012.

The increase in aggregate revenues was driven by an increase in investment banking and equity sales and trading revenues, partially offset by a decrease in fixed income and commodities sales and trading revenues.

Investment banking revenues reflect the impact of the financial advisory business that was transferred from MSCL to the Group effective from 1 January 2013 and also an improvement in transaction revenue.

Equity sales and trading revenues increased during the year compared to 2012 in line with increased trading volumes. The largest revenue increases were in cash equities and derivatives revenues. The derivatives revenues include the impact of the release of day one gains from the unwind of trades where valuation techniques included unobservable market data (see note 30e). Increased revenues also reflect the impact of reduced losses from derivative contracts and borrowings that are measured at fair value attributable to the tightening of Morgan Stanley's credit default swap spreads.

Fixed income and commodities sales and trading revenues decreased during the year compared to 2012. Reduced revenues were mainly driven by decreased interest rate derivatives and commodities revenues, partially offset by increased revenues within collateralised loan obligations and mortgage-backed securities products, and reduced losses from borrowings that are measured at fair value attributable to the tightening of Morgan Stanley's credit default swap spreads.

Aggregate results for the year exclude net day one gains of \$60 million (2012: \$141 million gains) not recognised upon initial recognition of financial instruments measured at fair value where valuation techniques include unobservable market data (see note 30e).

Other expense increased from \$3,402 million in 2012 to \$3,908 million in 2013 mainly driven by the transfer of the financial advisory business from MSCL to the Group effective from 1 January 2013, in addition to market movements on share based awards which contributed to the increases in direct staff costs and management recharges relating to staff costs.

The Group's effective tax rate for the year is 79% (2012: 96%) compared to that resulting from applying the average standard rate of corporation tax in the UK of 23.25% (2012: 24.5%). The main reason for the higher effective rate is attributed to the loss on disposal of subsidiaries that is non-tax deductible, and the impact of transferring taxable losses outside the Group for nil consideration. See note 8 for further details.

The consolidated statement of financial position is presented on page 20. The Group further strengthened its capital position during the year through the issuance of additional ordinary shares to its parent undertaking of \$3,050 million in return for the repurchase of its preference shares of \$1,050 million at par and cash proceeds of \$2,000 million. Total equity as at 31 December 2013 is \$15,659 million (2012: \$13,525 million).

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Overview of 2013 Financial Results (continued)

The Group's total assets and liabilities decreased by \$33,275 million and \$35,409 million respectively, a decrease of 6% respectively as at 31 December 2013 when compared to the restated* total assets and liabilities as at 31 December 2012. The decrease in total assets is driven by a decrease in securities purchased under agreements to resell of \$24,065 million primarily in client financing and facilitation business, and a decrease in financial assets held for trading of \$10,771 million primarily driven by a decrease in fixed income assets. The decrease in total liabilities is driven by reductions in financial liabilities classified as held for trading of \$31,284 million and securities sold under agreements to repurchase of \$15,678 million, offset by an increase in trade payables of \$14,785 million. The decreases were mainly due to increased netting benefits.

The consolidated statement of cash flows presented on page 21 shows a net increase in cash of \$669 million during the year (2012: net increase of \$323 million). Net cash flows used in operating activities were \$3,026 million (2012: \$1,519 million), offset by net proceeds from the issue and repurchase of shares of \$2,000 million and proceeds from disposal of subsidiaries and available-for-sale financial assets amounting to \$1,847 million (2012: \$1,979 million). Interest paid on subordinated debt was \$123 million (2012: \$137 million).

Key performance indicators

The Board of directors monitors the results of the Group by reference to a range of performance and risk based metrics, including, but not limited to the following:

Profitability and Return on Equity – The Group's operating margin (defined as net profit before tax as a percentage of aggregate revenues**) was 7.7% for the year ended 31 December 2013 (2012: 7.4%) and its return on equity (profit for the year as a percentage of total equity at the beginning of the year**) was 1.4% for the year ended 31 December 2013 (2012: 0.3%).

Balance Sheet Assets – Reducing the Group's total assets has been, and continues to be, a primary focus of the Group. The Group's total assets, as disclosed on page 20, decreased by 6% to \$520 billion at 31 December 2013.

Capital – The Group took steps during the year to improve its capital position in light of the implementation of Basel III in 2014 and leverage rules which are due to be phased in over future years. The Group increased its share capital by \$2,000 million during the year.

Market risk – The Group uses Value at Risk ("VaR") measures as a useful indicator of possible trading losses resulting from adverse daily market movements. The Group's average total VaR for risk management purposes ("Management VaR") for 2013 was \$22 million compared with \$30 million for 2012 and was below internal risk management targets.

*Details of the restatement are provided in note 2.

** Excludes the effect of the net currency translation loss on disposal of subsidiaries, see note 13.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management

Risk is an inherent part of the Group's business activity. The Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities in accordance with defined policies and procedures. The Group 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 Group's Board of directors and to appropriate senior management personnel of the Group as well as oversight through the Group's Board of directors and through a dedicated Risk Committee of non-executive directors that reports to the Board of Morgan Stanley International Limited ("MSI"), the Company's ultimate UK parent undertaking.

Note 26 to the consolidated financial statements provides more detailed qualitative and quantitative disclosures about the Group's management of and exposure to financial risks.

Set out below is an overview of the Group's policies for the management of financial risk and other significant business risks.

Market risk

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

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

The Group manages the market risk associated with its trading activities at both a trading division and an individual product level, which includes consideration of market risk for each significant legal entity within the Group.

The Group's Management VaR is a useful indicator of possible trading losses resulting from adverse daily market movements. Management VaR for the Primary Risk Categories for 2013 was \$20 million compared with \$24 million for 2012, with the decrease being mainly due to reduced exposure to interest rates and credit spreads. The average Credit Portfolio VaR for 2013 was \$8 million compared with \$14 million for 2012, with this decrease being due to decreased counterparty exposure during 2013. The average total Management VaR for 2013 was \$22 million compared with \$30 million for 2012.

Credit risk

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

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

The Group manages credit risk exposure on a consolidated basis and also for each significant legal entity within the Group. Its 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.

Country risk exposure

Country risk exposure is the risk that uncertainties arising from the economic, social, security and political conditions within a foreign country (any country other than the UK) will adversely affect the ability of the sovereign government and/or obligors within the country to honour their obligations to the Group.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Country risk exposure (continued)

Country risk exposure is measured in accordance with the Group's internal risk management standards and includes obligations from sovereign governments, corporations, clearing houses and financial institutions. The Group actively manages country risk exposure through a comprehensive risk management framework that allows the Group to effectively identify, monitor and limit country risk. Country risk exposure before and after hedges is monitored and managed.

The 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 Group conducts periodic stress testing that seeks to measure the impact of the Group's credit and market exposures of shocks stemming from negative economic or political scenarios. When deemed appropriate by the Group's risk managers, the stress test scenarios include possible contagion effects. Second order risks such as the impact for core European banks of their peripheral exposures may also be considered. The Group also conducts legal and documentation analysis of its exposures to obligors in peripheral jurisdictions, which are defined as exposures in Greece, Ireland, Italy, Portugal and Spain (the "European Peripherals"), to identify the risk that such exposures could be redenominated into new currencies or subject to capital controls in the case of country exit from the Eurozone. This analysis, and the results of the stress tests, may result in the amendment of limits or exposure mitigation.

The Group's sovereign exposures consist of financial instruments entered into with sovereign and local governments. Its non-sovereign exposures consist of exposures to primarily corporations and financial institutions. The Group has exposure to many foreign countries. The following table shows the Group's five largest non-UK country risk net exposures excluding exposures to European Peripherals which are disclosed separately. Exposure to other Morgan Stanley Group undertakings has been excluded from the tables below.

Each reference entity within an index is allocated to that reference entity's country of risk. Index exposures are allocated to the underlying reference entities in proportion to the notional weighting of each reference entity in the index, adjusted for any fair value receivable/payable for that reference entity. Where credit risk crosses multiple jurisdictions, for example, a credit default swap ("CDS") purchased from an issuer in a specific country that references bonds issued by an entity in a different country, the fair value of the CDS is reflected in the Net Counterparty Exposure column based on the country of the CDS issuer. Further, the notional amount of the CDS adjusted for the fair value of the receivable/payable is reflected in the Net Inventory column based on the country of the underlying reference entity.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Country risk exposure (continued)

Five largest non-UK country risk net exposures, excluding exposures to European Peripherals:

Country	Net inventory ⁽¹⁾ Smillions	Net counterparty exposure ⁽²⁾ Smillions	Funded lending Smillions	Unfunded commitments Smillions	Exposure before hedges Smillions	Hedges ⁽³⁾ Smillions	Net exposure ⁽⁴⁾ Smillions
Germany							
Sovereigns	(653)	703	-	-	50	(815)	(765)
Non-sovereigns	(771)	3,596	30	85	2,940	(319)	2,621
Total Germany	(1,424)	4,299	30	85	2,990	(1,134)	1,856
France							
Sovereigns	(376)	-	-	-	(376)	(11)	(387)
Non-sovereigns	(594)	1,501	-	1,435	2,342	(118)	2,224
Total France	(970)	1,501	-	1,435	1,966	(129)	1,837
United States							
Sovereigns	(717)	346	-	-	(371)	-	(371)
Non-sovereigns	(525)	1,835	-	-	1,310	(62)	1,248
Total United States	(1,242)	2,181	-	-	939	(62)	877
Russian Federation							
Sovereigns	(7)	-	-	-	(7)	-	(7)
Non-sovereigns	592	40	-	-	632	(35)	597
Total Russian Federation	585	40	-	-	625	(35)	590
Netherlands							
Sovereigns	(72)	5	-	-	(67)	(209)	(276)
Non-sovereigns	173	645	-	-	818	(125)	693
Total Netherlands	101	650	-	-	751	(334)	417

- (1) Net inventory represents exposure to both long and short single-name and index positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).
- (2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.
- (3) Represents CDS hedges (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (4) In addition, as at 31 December 2013, the Group had exposure to these countries for overnight deposits with banks of approximately \$641 million.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Country risk exposure (continued)

Country risk exposure to European Peripherals:

Country	Net inventory ⁽¹⁾ Smillions	Net counterparty exposure ⁽²⁾ Smillions	Unfunded commitments Smillions	CDS adjustments ⁽³⁾ Smillions	Exposure before hedges Smillions	Hedges ⁽⁴⁾ Smillions	Net exposure ⁽⁵⁾ Smillions
Greece							
Sovereigns	2	-	-	-	2	-	2
Non-sovereigns	88	-	-	-	88	-	88
Total Greece	90	-	-	-	90	-	90
Ireland							
Sovereigns	(6)	1	-	5	-	-	-
Non-sovereigns	204	34	-	2	240	-	240
Total Ireland	198	35	-	7	240	-	240
Italy							
Sovereigns	642	221	-	510	1,373	(215)	1,158
Non-sovereigns	(136)	689	239	32	824	(122)	702
Total Italy	506	910	239	542	2,197	(337)	1,860
Portugal							
Sovereigns	(264)	(1)	-	47	(218)	-	(218)
Non-sovereigns	(78)	26	-	20	(32)	(2)	(34)
Total Portugal	(342)	25	-	67	(250)	(2)	(252)
Spain							
Sovereigns	909	-	-	6	915	-	915
Non-sovereigns	160	125	103	11	399	(69)	330
Total Spain	1,069	125	103	17	1,314	(69)	1,245
Total European Peripherals	1,521	1,095	342	633	3,591	(408)	3,183

(1) Net inventory represents exposure to both long and short single-name and index positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).

(2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) takes into consideration legally enforceable master netting agreements and collateral.

(3) CDS adjustment represents credit protection purchased from European Peripherals' banks on European Peripherals' sovereign and financial institution risk. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(4) Represents CDS hedges (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(5) In addition, as at 31 December 2013, the Group had European Peripherals exposure for overnight deposits with banks of approximately \$43 million.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Liquidity and funding risk

Liquidity and funding risk refers to the risk that the Group will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity and funding risk also encompasses the Group's ability to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten its viability as a going concern.

The primary goal of the Group's liquidity and funding risk management framework is to ensure that the Group has access to adequate funding across a wide range of market conditions. The framework is designed to enable the Group, to fulfil its financial obligations and support the execution of its business strategies. The Group's key components of liquidity and funding risk management include its Contingency Funding Plan ("CFP"), Liquidity Stress Testing and Liquidity Reserve, which are further described in note 26.

The Group 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, and to meet regulatory stress testing requirements proposed by its regulators.

Operational risk

Operational risk refers to the risk of loss, or of damage to the Group's reputation, resulting from inadequate or failed processes, people and systems or from external events. This definition includes legal and regulatory risk.

Operational risk management policies and procedures for the Group are consistent with those of the Morgan Stanley Group and include escalation to the Group's Board of directors and appropriate senior management personnel. The operational risk management framework operates to identify, measure, monitor and control risk in the context of an approved a risk tolerance appetite set by the Board of directors.

The Group's business is highly dependent its ability to process, on a daily basis, a large number of transactions across numerous and diverse markets in many currencies. In addition, new products or services may be introduced or change processes, resulting in new operational risk that may not be fully appreciated or identified. In general, the transactions processed are increasingly complex. The Group relies on the ability of the Morgan Stanley Group's employees, its internal systems, and systems at technology centres operated by unaffiliated third parties to process a high volume of transactions.

The Group also faces the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries it uses to facilitate securities transactions. In the event of a breakdown or improper operation of the Group's or a third party's systems or improper or unauthorised action by third parties or the Morgan Stanley Group's employees, the Group could suffer financial loss, an impairment to its liquidity, a disruption of its businesses, regulatory sanctions or damage to its reputation. In addition, the interconnectivity of multiple financial institutions with central agencies, exchanges and clearing houses, and the increased importance of these entities, increases the risk that an operational failure at one institution or entity may cause an industry-wide operational failure that could materially impact the Group's ability to conduct business.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Operational risk (continued)

The Group's operations rely on the secure processing, storage and transmission of confidential and other information in its computer systems and the systems of third parties with which the Group does business with or that facilitate its business activities, such as vendors. Like other financial services firms, the Group and its third party providers have been and continue to be subject to unauthorised access, mishandling or misuse, computer viruses or malware cyber attacks, denial of service attacks and other events. Events such as these could have a security impact on the Group's systems and jeopardise the Group's or the Group's clients' or counterparties' personal, confidential, proprietary or other information processed and stored in, and transmitted through, the Group's and its third party providers' computer systems. Furthermore, such events could cause interruptions or malfunctions in the Group's, the Group's clients', the Group's counterparties' or third parties' operations, which could result in reputational damage, client dissatisfaction, litigation or regulatory fines or penalties not covered by insurance maintained by the Group, and adversely affect the business, financial condition or results of operations.

The Group is exposed to legal and regulatory risk including the risk of exposure to fines, penalties, judgements, damages and/or settlements in connection with regulatory or legal actions as a result of non-compliance with applicable legal or regulatory requirements and standards or litigation. Legal risk also includes contractual and commercial risk such as the risk that a counterparty's performance obligations will be unenforceable. The Group is generally subject to extensive regulation in the different jurisdictions in which it conducts its business. In the current environment of rapid and possibly transformational regulatory change, the Group also views regulatory change as a component of legal risk.

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

Significant changes in the way that major financial services institutions are regulated are occurring in the UK, Europe, the US and worldwide. The reforms being discussed and, in some cases, already implemented, include several that contemplate comprehensive restructuring of the regulation of the financial services industry. Such measures will likely lead to stricter regulation of financial institutions generally, and heightened prudential requirements for systemically important firms in particular. Such measures could include reforms of the over-the-counter ("OTC") derivatives markets, such as mandated exchange trading and clearing, position limits, margin, capital and registration requirements. Changes in tax legislation in the UK and worldwide, such as increased taxation of financial transactions, liabilities and employees' compensation, are also possible.

MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Capital management

The Group views capital as an important source of financial strength. It actively manages and monitors its capital in line with established policies and procedures and in compliance with local regulatory requirements. The Group further strengthened its capital position during the year through the issuance of additional ordinary shares to its parent undertaking of \$3,050 million in return for the repurchase of its preference shares of \$1,050 million and cash proceeds of \$2,000 million. The Group's capital management is further described in note 32.

Going Concern

Business risks associated with the uncertain market and economic conditions are being actively monitored and managed by the Group. Retaining sufficient liquidity and capital to withstand these market pressures remains central to the Group's strategy. In particular, the Group's capital and liquidity is deemed sufficient to exceed regulatory minimums under both a normal and in a stressed market environment for the foreseeable future. Additionally, the Group has access to further Morgan Stanley Group capital and liquidity as required.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Group will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly they continue to adopt the going concern basis in preparing the annual reports and financial statements.

Approved by the Board and signed on its behalf by



I PLENDERLEITH

Director

23 April 2014

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

The Directors present their report and consolidated financial statements of Morgan Stanley & Co. International plc (the "Company") and all of its subsidiary undertakings (together "the Group"), which comprise the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity, consolidated statement of financial position, consolidated statement of cash flows and the related notes 1 to 35, together with the Company's balance sheet and related notes 1 to 20 for the year ended 31 December 2013.

RESULTS AND DIVIDENDS

The Group's profit for the year, after tax, was \$37 million (2012: \$9 million profit after tax).

During the year, a dividend of \$1 million was declared on the Class C preference shares (2012: \$1 million) and a dividend of \$88 million was declared on the Class D1 preference shares (2012: \$nil). No final dividends are proposed (2012: \$nil).

REGULATION

Since 1 April 2013, the Company has been authorised by the Prudential Regulation Authority ("PRA") and regulated by the Financial Conduct Authority ("FCA") and the PRA. Prior to 1 April 2013 the Company was authorised and regulated by the Financial Services Authority ("FSA").

RISK MANAGEMENT, BRANCHES AND FUTURE DEVELOPMENTS

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

BASEL II PILLAR 3 DISCLOSURES

The disclosures made in order to comply with the PRA's rules on regulatory disclosure for Pillar 3 purposes, which implement in the UK the European Union ("EU") Directives underlying the revised capital adequacy framework, are available on the Morgan Stanley website (see note 32 for further details). With effect from 1 January 2014, the PRA rules are replaced by direct reference to the EU's Capital Requirements Regulation.

CAPITAL REQUIREMENTS COUNTRY-BY-COUNTRY REPORTING

The disclosures made in order to comply with the Capital Requirements (Country-by-Country Reporting) Regulations 2013 will be made available on the Morgan Stanley website by 1 July 2014 (see note 32 for further details).

DIRECTORS

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

C D S Bryce	
D O Cannon	(appointed 1 June 2013)
Sir E J W Gieve	
T C Kelleher	(resigned as Chairman 1 January 2014)
N S Nandra	(appointed 20 March 2013 and resigned 16 April 2013)
F R Petitgas	
M C Phibbs	(appointed 1 May 2013)
I Plenderleith	(appointed as Chairman 1 January 2014)
R P Rooney	
D A Russell	
L Bini Smaghi	(appointed 1 October 2013 and resigned 31 March 2014)
C E Woodman	

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance is taken out by Morgan Stanley, for the benefit of the Directors and Officers of the Group.

DIRECTORS' INDEMNITY

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

AUDIT COMMITTEE

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

EMPLOYEES

Both the Group and the Morgan Stanley Group place considerable value on the investment in their employees and have continued their practice of keeping employees informed on matters affecting them. Employees are encouraged to present their suggestions and views on Morgan Stanley Group's performance to management and employees participate directly in the success of the business through Morgan Stanley Group's various compensation incentive plans.

Every effort is also made to ensure that disabled applicants, or those existing employees who are disabled or may have become disabled, are treated as fairly as possible on terms comparable with those of other employees. Appropriate training is arranged for disabled persons, including retraining for alternative work for employees who become disabled, to promote their career development within the organisation.

EMPLOYEE REMUNERATION

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

CHARITABLE CONTRIBUTIONS

During the year the Group made donations to various charities totaling \$2.2 million (2012: \$1.8 million) of which \$1.4 million was donated to the Morgan Stanley International Foundation (2012: \$1.6 million).

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

AUDITOR

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

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 Group's auditor in connection with preparing their report) of which the Group'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 Group'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



I PLENDERLEITH

Director

23 April 2014

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

DIRECTORS' RESPONSIBILITIES STATEMENT

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

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared 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 company law the Directors must not approve the accounts unless they are satisfied that they give a true and fair view of the state of affairs of the Group and of the profit or loss of the Group for that period.

In preparing the Group financial statements, the Directors are required by IAS 1 '*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 Group's ability to continue as a going concern.

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

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK accounting standards have been followed; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group's transactions and disclose with reasonable accuracy at any time the financial position of the Group 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 Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors, the names of whom are set out on page 11 of the Directors' report, confirm to the best of their knowledge:

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

Approved by the Board and signed on its behalf by

Director
23 April 2014



I PLENDERLEITH

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

We have audited the Group and Company financial statements of Morgan Stanley & Co. International plc for the year ended 31 December 2013 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity, the consolidated statement of financial position and the consolidated statement of cash flows and the Company balance sheet and the related notes 1 to 35 for the consolidated financial statements and the related notes 1 to 20 for the Company financial statements. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and IFRSs as adopted by the EU. The financial reporting framework that has been applied in the preparation of the Company financial statements is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the Group's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Group's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Group and the Group's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditor

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

Scope of the audit of the financial statements

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

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Group's and of the parent Company's affairs as at 31 December 2013 and of the Group's profit for the year then ended;
- for the Group have been properly prepared in accordance with IFRSs as adopted by the EU;
- for the parent Company have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

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

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

Matters on which we are required to report by exception

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

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



Robert Topley (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London
23 April 2014

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED INCOME STATEMENT

Year ended 31 December 2013

	Note	2013 \$millions	Restated 2012 \$millions
Net gains on financial instruments classified as held for trading		4,082	3,571
Net gains on financial instruments designated at fair value through profit or loss		135	96
Net gains on available-for-sale financial assets	4	5	50
Interest income	5	1,217	1,513
Interest expense	5	(1,610)	(1,950)
Other income	6	403	394
Other expense	7	(3,908)	(3,402)
Net currency translation loss on disposal of subsidiaries	13	(151)	(30)
PROFIT BEFORE INCOME TAX		<u>173</u>	<u>242</u>
Income tax expense	8	(136)	(233)
PROFIT FOR THE YEAR		<u><u>37</u></u>	<u><u>9</u></u>
Attributable to:			
Owners of the parent		35	8
Non-controlling interests		2	1
PROFIT FOR THE YEAR		<u><u>37</u></u>	<u><u>9</u></u>

All operations were continuing in the current and prior year.

The notes on pages 22 to 117 form an integral part of the consolidated financial statements.

Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
Year ended 31 December 2013

	Note	2013 \$millions	2012 \$millions
PROFIT FOR THE YEAR		37	9
OTHER COMPREHENSIVE INCOME, NET OF TAX			
Items that will not be reclassified subsequently to profit or loss:			
Remeasurement of net defined benefit liability	8	2	-
Items that may be reclassified subsequently to profit or loss:			
Currency translation reserve:			
Foreign currency translation differences arising on foreign operations		35	24
Net loss reclassified to the consolidated income statement	13	151	30
Available-for-sale reserve:			
Net change in fair value of available-for-sale financial assets	8	4	23
Net loss reclassified to the consolidated income statement	8	(4)	(35)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	8	(2)	(3)
OTHER COMPREHENSIVE INCOME AFTER INCOME TAX FOR THE YEAR		186	39
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		<u>223</u>	<u>48</u>
Attributable to:			
Owners of the parent		218	45
Non-controlling interests		5	3
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		<u>223</u>	<u>48</u>

The notes on pages 22 to 117 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
Year ended 31 December 2013

	Note	Share capital \$millions	Share premium \$millions	Currency translation reserve \$millions	Available-for-sale reserve \$millions	Capital contribution reserve \$millions	Capital redemption reserve \$millions	Retained earnings \$millions	Attributable to owners of the parent \$millions	Non-controlling interests \$millions	Total equity \$millions
Balance at 1 January 2012		9,464	513	(157)	16	3	1,399	2,169	13,407	71	13,478
Profit for the year		-	-	-	-	-	-	8	8	1	9
Other comprehensive income/ (loss):											
Currency translation reserve:											
Foreign currency translation differences arising on foreign operations		-	-	22	-	-	-	-	22	2	24
Net amount reclassified to consolidated income statement	13	-	-	30	-	-	-	-	30	-	30
Available-for-sale reserve:											
Net change in fair value of available-for-sale financial assets	8	-	-	-	23	-	-	-	23	-	23
Net amount reclassified to consolidated income statement	8	-	-	-	(35)	-	-	-	(35)	-	(35)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	8	-	-	-	-	-	-	(3)	(3)	-	(3)
Total comprehensive income/ (loss)		-	-	52	(12)	-	-	5	45	3	48
Transactions with owners:											
Dividends	22	-	-	-	-	-	-	(1)	(1)	-	(1)
Balance at 31 December 2012		9,464	513	(105)	4	3	1,399	2,173	13,451	74	13,525
Profit for the year		-	-	-	-	-	-	35	35	2	37
Other comprehensive income/ (loss):											
Remeasurement of net defined benefit liability	8	-	-	-	-	-	-	2	2	-	2
Currency translation reserve:											
Foreign currency translation differences arising on foreign operations		-	-	32	-	-	-	-	32	3	35
Net amount reclassified to consolidated income statement	13	-	-	151	-	-	-	-	151	-	151
Available-for-sale reserve:											
Net change in fair value of available-for-sale financial assets	8	-	-	-	4	-	-	-	4	-	4
Net amount reclassified to consolidated income statement	8	-	-	-	(4)	-	-	-	(4)	-	(4)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	8	-	-	-	-	-	-	(2)	(2)	-	(2)
Total comprehensive income/ (loss)		-	-	183	-	-	-	35	218	5	223
Transactions with owners:											
Dividends	22	-	-	-	-	-	-	(89)	(89)	-	(89)
Issuance of share capital	21	3,050	-	-	-	-	-	-	3,050	-	3,050
Repurchase of preference shares	21	(1,050)	-	-	-	-	-	-	(1,050)	-	(1,050)
Balance at 31 December 2013		11,464	513	78	4	3	1,399	2,119	15,580	79	15,659

The notes on pages 22 to 117 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

Registered number: 2068222

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
As at 31 December 2013

	Note	2013 Smillions	Restated 31 December 2012 Smillions	Restated 1 January 2012 Smillions
ASSETS				
Loans and receivables:				
Cash and short term deposits	23	12,244	11,526	11,180
Cash collateral on securities borrowed		17,372	19,733	18,141
Securities purchased under agreements to resell		75,717	99,782	97,218
Trade receivables		72,220	66,438	67,371
Other receivables	9	2,965	5,676	7,225
		<u>180,518</u>	<u>203,155</u>	<u>201,135</u>
Financial assets classified as held for trading (of which \$45,178 million (2012: \$42,457 million) were pledged to various parties)				
	10	330,923	341,694	354,143
Financial assets designated at fair value through profit or loss	11	7,673	7,591	8,562
Available-for-sale financial assets	12	60	40	67
Current tax assets		229	210	145
Deferred tax assets	19	115	91	44
Prepayments and accrued income		43	53	45
Property, plant and equipment	15	5	7	10
TOTAL ASSETS		<u>519,566</u>	<u>552,841</u>	<u>564,151</u>
LIABILITIES AND EQUITY				
Financial liabilities at amortised cost:				
Bank loans and overdrafts	23	16	23	124
Cash collateral on securities loaned		13,457	17,766	14,582
Securities sold under agreements to repurchase		70,016	85,694	76,904
Trade payables		97,946	83,161	83,626
Subordinated loans	16	7,906	7,906	7,906
Other payables	17	18,179	17,616	21,707
		<u>207,520</u>	<u>212,166</u>	<u>204,849</u>
Financial liabilities classified as held for trading	10	282,764	314,048	333,825
Financial liabilities designated at fair value through profit or loss	11	13,123	12,560	11,710
Provisions	18	30	82	10
Current tax liabilities		242	243	68
Deferred tax liabilities	19	3	4	7
Accruals and deferred income		221	208	200
Post employment benefit obligations	34	4	5	4
TOTAL LIABILITIES		<u>503,907</u>	<u>539,316</u>	<u>550,673</u>
EQUITY				
Share capital	21	11,464	9,464	9,464
Share premium account		513	513	513
Currency translation reserve		78	(105)	(157)
Available-for-sale reserve		4	4	16
Capital contribution reserve		3	3	3
Capital redemption reserve		1,399	1,399	1,399
Retained earnings		2,119	2,173	2,169
Equity attributable to the owners of the parent		<u>15,580</u>	<u>13,451</u>	<u>13,407</u>
Non-controlling interests		79	74	71
TOTAL EQUITY		<u>15,659</u>	<u>13,525</u>	<u>13,478</u>
TOTAL LIABILITIES AND EQUITY		<u>519,566</u>	<u>552,841</u>	<u>564,151</u>

These consolidated financial statements were approved by the Board and authorised for issue on 23 April 2014. Signed on behalf of the Board

Director



I. PLENDERLEITH

The notes on pages 22 to 117 form an integral part of the consolidated financial statements.
Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED STATEMENT OF CASH FLOWS
Year ended 31 December 2013

	Note	2013 \$millions	2012 \$millions
NET CASH FLOWS USED IN OPERATING ACTIVITIES	23b	(3,026)	(1,519)
INVESTING ACTIVITIES			
Purchase of property, plant and equipment	15	(1)	(1)
Purchase of available-for-sale financial assets	12	(27)	(2)
Proceeds from disposal of available-for-sale financial assets	12	12	59
Dividends received from available-for-sale financial assets	4	-	4
Proceeds from disposal of subsidiaries, net of cash disposed	13	1,835	1,920
NET CASH FLOWS FROM INVESTING ACTIVITIES		<u>1,819</u>	<u>1,980</u>
FINANCING ACTIVITIES			
Issue of ordinary share capital	21	3,050	-
Repurchase of preference shares	21	(1,050)	-
Interest on subordinated loan liabilities		(123)	(137)
Dividends paid to owners of the parent	22	(1)	(1)
NET CASH FLOWS FROM/(USED IN) FINANCING ACTIVITIES		<u>1,876</u>	<u>(138)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS		669	323
Currency translation differences on foreign currency cash balances		56	124
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	23a	<u>11,503</u>	<u>11,056</u>
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	23a	<u>12,228</u>	<u>11,503</u>

The notes on pages 22 to 117 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

1. CORPORATE INFORMATION

The Company is incorporated in the UK and registered in England and Wales, at the following address:
25 Cabot Square, Canary Wharf, London, E14 4QA.

On 12 December 2013, the Group's immediate parent undertaking changed from Morgan Stanley UK Group to Morgan Stanley Investments (UK) as a result of Morgan Stanley UK Group contributing its holding in the Company to Morgan Stanley Investments (UK). Morgan Stanley Investments (UK) is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.

The Group's ultimate parent undertaking and controlling entity is Morgan Stanley which, together with the Group and Morgan Stanley's other subsidiary undertakings, form the Morgan Stanley Group. Morgan Stanley is incorporated in the state of Delaware, the United States of America.

2. BASIS OF PREPARATION

Statement of compliance

The Group has prepared its annual consolidated financial statements in accordance with IFRSs issued by the IASB as adopted by the EU, Interpretations issued by the IFRS Interpretations Committee ("IFRIC") and the UK Companies Act 2006.

New standards and interpretations adopted during the year

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

An amendment to IAS 1 was issued by the IASB in June 2011 for application in annual periods beginning on or after 1 July 2012. The revised standard was endorsed by the EU in June 2012. The consolidated statement of comprehensive income now presents items net of tax and analysed between those that may be and those that will not be reclassified subsequently to profit or loss.

An amendment to IAS 19 '*Employee benefits*' ("IAS 19") was issued by the IASB in June 2011 for retrospective application in annual periods beginning on or after 1 January 2013. The revised standard was endorsed by the EU in June 2012. The Group adopted this amendment in accordance with the transitional provisions set out in the standard. The amendment requires more extensive disclosures around the characteristics and risks of the Group's benefit plans, which are included in note 34.

IAS 27 '*Consolidated and separate financial statements*' ("IAS 27") and IAS 28 '*Investment in associates and joint ventures*' ("IAS 28") were revised by the IASB in May 2011, for application in annual periods beginning on or after 1 January 2013. The revised standards were endorsed by the EU in December 2012 such that a group shall apply them at the latest from the commencement date of its first financial year starting on or after 1 January 2014. The Group adopted IAS 27 and IAS 28 with effect from 1 January 2013.

An amendment to IFRS 7 '*Financial instruments: Disclosures – offsetting financial assets and financial liabilities*' ("IFRS 7") was issued by the IASB in December 2011 for retrospective application in annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendment was endorsed by the EU in December 2012. The amendments require disclosures regarding the Group's financial instruments that are either offset in the consolidated statement of financial position or subject to an enforceable master netting arrangement or similar agreement, which are included in note 29.

IFRS 10 '*Consolidated financial statements*' ("IFRS 10"), IFRS 11 '*Joint arrangements*' ("IFRS 11") and IFRS 12 '*Disclosure of interests in other entities*' ("IFRS 12") were issued by the IASB in May 2011 for retrospective application in annual periods beginning on or after 1 January 2013. The standards were endorsed by the EU in December 2012 requiring application no later than annual periods starting 1 January 2014.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

2. BASIS OF PREPARATION (CONTINUED)

New standards and interpretations adopted during the year (continued)

In addition, amendments to IFRS 10, IFRS 11 and IFRS 12 were issued by the IASB in June 2012 for retrospective application in annual periods on or after 1 January 2013. The amendments were endorsed by the EU in April 2013 requiring application no later than annual periods starting 1 January 2014. The Group chose to early adopt IFRS 10, IFRS 11 and IFRS 12 with effect from 1 January 2013. There has been no material impact to the Group as a result of adopting IFRS 10 and IFRS 11. IFRS 12 requires more extensive disclosures on interests held in structured entities, which are included in note 14.

IFRS 13 '*Fair value measurement*' ("IFRS 13") was issued by the IASB in May 2011 for prospective application in annual periods beginning on or after 1 January 2013 and was endorsed by the EU in December 2012. There was no material impact to the Group as a result of adopting the measurement requirements of IFRS 13. Additional disclosures required by IFRS 13 are included in notes 30 and 31.

As part of the May 2012 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IAS 1, IAS 32 '*Financial Instruments: Presentation*' ("IAS 32") and IAS 34 '*Interim financial reporting*' (for application in accounting periods beginning on or after 1 January 2013). The improvements were endorsed by the EU in March 2013.

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

New standards and interpretations not yet adopted

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

An amendment to IAS 32 was issued by the IASB in December 2011, for retrospective application in annual periods beginning on or after 1 January 2014. The amendment was endorsed by the EU in December 2012.

An amendment to IAS 36 '*Recoverable amount disclosures for non-financial assets*' was issued by the IASB in May 2013, for retrospective application in annual periods beginning on or after 1 January 2014. The amendment was endorsed by the EU in December 2013.

An amendment to IAS 19 was issued by the IASB in November 2013, for retrospective application for annual periods beginning on or after 1 July 2014.

IFRS 9 '*Financial instruments*' ("IFRS 9") was issued by the IASB in November 2009. Amendments to IFRS 9 were issued by the IASB in November 2013. Although there are expected to be significant changes to the presentation of financial instruments by the Group, there is not expected to be a significant impact on net assets. Retrospective application is required and IFRS 9 is anticipated to be effective for annual periods beginning on or after 1 January 2018, however the early adoption of amendments relating to own credit is permitted.

Amendments to IFRS 10, IFRS 12 and IAS 27 '*Investment entities*' were issued by the IASB in October 2012 for application in annual periods beginning on or after 1 January 2014. The amendments were endorsed by the EU in November 2013.

IFRIC 21 '*Levies*' was issued by the IASB in May 2013 for retrospective application in annual periods beginning on or after 1 January 2014.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

2. BASIS OF PREPARATION (CONTINUED)

New standards and interpretations not yet adopted (continued)

As part of the December 2013 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 2 '*Share-based Payment*' ("IFRS 2"), IFRS 3 '*Business Combinations*', IFRS 8 '*Operating Segments*', IFRS 13, IAS 16 '*Property, Plant and Equipment*', IAS 24 '*Related Party Disclosures*' and IAS 38 '*Intangible Assets*' for application in accounting periods beginning on or after 1 July 2014.

Basis of measurement

The consolidated financial statements of the Group 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.

Restatement of comparative amounts

The consolidated income statement includes a prior year adjustment in order to reduce both interest income and interest expense by \$1,083 million. This relates to interest income and expense that was incorrectly presented gross. This error had no impact on the Group's profit for the year. Notes 23(b) and 35 have been revised as a result of this restatement.

The consolidated statement of financial position includes a prior year adjustment relating to certain cash collateral on securities borrowed and loaned balances which were previously presented gross by an amount of \$11,570 million, but which do qualify for netting under IAS 32 *Financial Instruments: Presentation*. This restatement resulted in reductions in cash collateral on securities borrowed and total assets, and in cash collateral on securities loaned and total liabilities, of \$11,570 million. There was no impact on the Group's net assets. Notes 23(b), 24, 25, 26, 29 and 35 have also been revised as a result of this restatement.

Use of estimates and sources of uncertainty

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

For further details on judgements used in determining whether the Group should consolidate a structured entity and in determining the fair value of certain assets and liabilities, see notes 14 and 30.

Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of the Company and its subsidiaries as at 31 December 2013. Subsidiaries are all entities over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The financial statements of the subsidiaries are prepared for the same reporting year as the Group, using consistent accounting policies. The financial statements of overseas subsidiaries are translated into US dollars as described in note 3(b). Subsidiaries are consolidated from the date that the Group gains control until the date that control ceases.

In certain cases, the Group may exercise control over another entity on behalf of investors or other parties. In such cases it is necessary, as part of the assessment of whether it should consolidate the entity, for the Group to determine whether it exercises such control primarily as an agent for the other investors or whether it does so primarily as principal on its own behalf. In making such a determination, the Group will consider all relevant factors, including in particular:

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

2. BASIS OF PREPARATION (CONTINUED)

Basis of consolidation (continued)

- the scope of the Group's decision-making authority over the investee;
- the rights, including removal rights, held by other parties;
- the remuneration to which the Group is entitled; and
- the significance of the Group's exposure to variability of returns from its interests in the entity.

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

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

Details of the Group's interests in other entities are given in note 13 to these financial statements.

The going concern assumption

The Group'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 10. In addition, the notes to the consolidated financial statements include the Group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments; and its exposures to credit risk and liquidity risk.

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

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Group will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual reports and consolidated financial statements.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Functional currency

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

All currency amounts in the consolidated financial statements, Strategic report and Directors' report are rounded to the nearest million US dollars (unless otherwise stated).

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. Foreign exchange differences on available-for-sale financial assets are recorded in the 'Available-for-sale reserve' in equity, with the exception of translation differences on the amortised cost of monetary available-for-sale assets, which are recognised through the consolidated income statement. Assets and liabilities of foreign operations are translated into US dollars using the closing rate method. Translation differences arising from the net investments in the foreign operations are taken to the 'currency translation reserve'. All other translation differences are taken through the consolidated income statement.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

b. Foreign currencies (continued)

Exchange differences recognised in the consolidated income statement are presented in 'Other income' or 'Other expense', except where noted in 3(c) below.

On disposal of a foreign operation, the related cumulative gain or loss in the 'currency translation reserve' attributable to the owners of the parent is reclassified to the consolidated income statement and recorded within net currency translation gain / (loss) on disposal of subsidiary.

c. Financial instruments

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

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

More information regarding these classifications is included below:

i) Financial instruments classified as held for trading

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

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

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

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

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

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

From the date the transaction in a financial instrument designated at fair value through profit or loss is entered into (trade date) until settlement date, the Group recognises any unrealised fair value changes in the contract as financial instruments designated at fair value through profit or loss. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at fair value through profit or loss (see note 3(d) below).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS **Year ended 31 December 2013**

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

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

All subsequent changes in fair value, foreign exchange differences, interest and dividends are reflected in the consolidated income statement in 'Net gains/ (losses) on financial instruments designated at fair value through profit or loss'.

Transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated income statement in 'Other expense'.

iii) Available-for-sale financial assets

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

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

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

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

iv) Loans and receivables and financial liabilities at amortised cost

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

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

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.

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

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.

Where the Group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market or credit risk, the Group 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.

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

The hierarchy is broken down into three levels based on the observability of inputs as follows:

- Level 1 - Quoted prices (unadjusted) in an active market for identical assets or liabilities

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Fair value measurement (continued)

- 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 Group in determining fair value is greatest for instruments categorised in Level 3 of the fair value hierarchy.

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

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

Valuation techniques

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

Fair value for many cash and OTC contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity), as well as multiple inputs including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk.

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Valuation techniques (continued)

Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in its own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty's credit spreads is considered when measuring the fair value of assets. For OTC derivatives, the impact of changes in both the Group's and the counterparty's credit standing is considered when measuring fair value. In determining the expected exposure the Group simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party CDS spread data. Where CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. The Group also considers collateral held and legally enforceable master netting agreements that mitigate the Group's exposure to each counterparty.

Adjustments for model uncertainty are taken for positions where underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible. The Group generally subjects all valuations and models to a review process initially and on a periodic basis thereafter.

The Group may apply a concentration adjustment to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk exposure. Where possible, these adjustments are based on observable market information but in many instances significant judgement is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

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

Valuation process

The Valuation Review Group ("VRG") within the Financial Control Group ("FCG") is responsible for the Group'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 Group's financial instruments. VRG implements valuation control processes to validate the fair value of the Group's financial instruments measured at fair value including those derived from pricing models. These control processes are designed to ensure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to ensure that the valuation approach utilised is appropriate and consistently applied and that the assumptions are reasonable.

The Group's control processes apply to all financial instruments, unless otherwise noted. These control processes include:

- *Model Review.* VRG, in conjunction with the Market Risk Department and, where appropriate, the Credit Risk Management Department, both of which report to the Chief Risk Officer of the Morgan Stanley Group ("CRO"), independently review 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 ensure 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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Valuation process (continued)

As part of the review, VRG develops a methodology to independently verify the fair value generated by the business unit's valuation model. Before trades are executed using new valuation models, those models are required to be independently reviewed. All of the Group's valuation models are subject to an independent annual VRG review.

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

VRG uses recently executed transactions, other observable market data such as exchange data, broker/dealer quotes, third-party pricing vendors and aggregation services for validating the fair values of financial instruments generated using valuation models. VRG assesses the external sources and their valuation methodologies to determine if the external providers meet the minimum standards expected of a third-party pricing source. Pricing data provided by approved external sources 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 to ensure that the highest-ranked market data source is used to validate the business unit's fair value of financial instruments.

For financial instruments where the fair value is based on unobservable inputs, VRG reviews the business unit's valuation techniques to ensure these are consistent with market participant assumptions.

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

- *Review of Transactions where the valuation is based on unobservable inputs.* VRG reviews the models and valuation methodology used to price all new material Level 3 transactions and both FCG and Market Risk Department management must approve the fair value of the trade that is initially recognised.

Gains and losses on inception

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

When 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 consolidated income statement and is recognised instead when the market data becomes observable.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

e. Derecognition of financial assets and liabilities

The Group derecognises a financial asset only 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.

The Group derecognises financial liabilities when the Group'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 either available-for-sale or loans and receivables. Impairment losses are recognised if an event has occurred which will have an adverse impact on the expected future cash flows of an asset and the expected impact can be reliably estimated.

Impairment losses on available-for-sale financial assets are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value. Where there is evidence that the available-for-sale financial asset is impaired, the cumulative loss that had been previously recognised in other comprehensive income is reclassified from the 'Available-for-sale reserve' and recognised in the consolidated income statement within 'Net gains/ (losses) on available-for-sale financial assets'.

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 consolidated income statement within 'Other expense' and are recognised against the carrying amount of the impaired asset on the consolidated statement of financial position. Interest on the impaired asset continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset.

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

g. Impairment of non-financial assets

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

h. Fees and commissions

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

i. Property, plant and equipment

Property, plant and equipment are stated at cost net of depreciation and any provision for impairment in value, which are included within 'Other expense' in the consolidated income statement.

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

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

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

j. Business combinations and disposals

i) Combination of businesses

Business combinations are accounted for using the acquisition method of accounting.

Consideration for each acquisition is measured at the date at which a business combination occurs (the "acquisition date") at the fair value of the assets transferred, liabilities incurred (including any asset or liability resulting from a contingent consideration arrangement) and equity instruments issued by the Group in exchange for control of the acquiree.

Acquisition related costs are recognised in the consolidated income statement as incurred.

Identifiable assets acquired and liabilities (including contingent liabilities) assumed, which meet the conditions for recognition under IFRS 3 (revised) '*Business combinations*', are recognised initially at acquisition-date fair values, with the exception that:

- deferred tax assets and liabilities are recognised and measured in accordance with IAS 12 '*Income taxes*';
- assets related to employee benefit arrangements are recognised and measured in accordance with IAS 19;
- liabilities or equity instruments related to the replacement of an acquiree's share-based payment award are measured in accordance with IFRS 2, and
- acquired non-current assets or disposal groups that are classified as held for sale at the acquisition date in accordance with IFRS 5 '*Non-current assets held for sale and discontinued operations*' are reported at their fair value less cost to sell.

A contingent liability assumed is recognised where it is a present obligation that arises from past events and its fair value can be measured reliably, regardless of whether it is probable that an outflow of resources will be required to settle the obligation.

A non-controlling interest in the acquiree is recognised (in respect of any portion of the total assets less total liabilities of an acquired entity that is not owned by the Group) at fair value.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS **Year ended 31 December 2013**

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

j. Business combinations and disposals (continued)

i) Combination of businesses (continued)

Any excess of the sum of the consideration and the amount of any non-controlling interest in the acquiree over the fair value of the identifiable assets acquired less liabilities assumed, is recognised as goodwill. If the sum of the consideration and the amount of any non-controlling interest in the acquiree is less than the fair value of the identifiable assets acquired less liabilities assumed, the gain on acquisition is recognised in the consolidated income statement in the year of acquisition.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurred, the Group reports provisional amounts for the items for which the accounting is incomplete. The measurement period (which may not exceed one year) is the period from the date of acquisition to the date the Group obtains complete information about the facts and circumstances that existed as of the acquisition date. Provisional amounts may be adjusted during the measurement period, or additional assets or liabilities recognised, to reflect any new information obtained about the facts and circumstances that existed at the acquisition date that, if known, would have affected the amounts recognised at that date.

Subsequent changes to the fair value of any asset or liability resulting from a contingent consideration arrangement during the measurement period are adjusted against the cost of acquisition. Changes in the fair value of contingent consideration classified as equity are not recognised.

Post-acquisition, income received and expenses incurred by the entity or entities acquired are included in the consolidated income statement on a line-by-line basis in accordance with the accounting policies set out herein.

When subsidiaries are sold or the Group ceases to control an entity, the difference between the proceeds (plus the fair value of any investment retained), and the total assets less total liabilities disposed of, cumulative translation differences and unamortised goodwill, is recognised in the consolidated income statement within 'Gain/ (loss) on disposal of subsidiary'. Where the disposal or loss of control over an entity includes a foreign operation, all foreign exchange differences accumulated in the 'Currency translation reserve' attributable to the equity holders of the Company are reclassified to the consolidated income statement within 'Gain/ (loss) on disposal of subsidiary'.

ii) Combination of businesses under common control

Business combinations involving entities under common control, where all combining entities are ultimately controlled by the same entity before and after the business combination, are accounted for using the predecessor values method of accounting. This involves recognising assets and liabilities of the acquired business at the predecessors' book value, without any change to reflect fair value of those assets and liabilities. Any difference between the cost of acquisition and the aggregate book value of the assets and liabilities as of the date of the transfer of the acquired entity is recorded as an adjustment to equity within the 'Capital contribution reserve'. No additional goodwill is created by the business combination.

Post-acquisition, income received and expenses incurred by the entity or entities acquired are included in the consolidated income statement on a line-by-line basis in accordance with the accounting policies set out herein.

A non-controlling interest is recognised by the Group in respect of any portion of the total assets less total liabilities of an acquired entity or entities that is not owned by the Group.

When subsidiaries are sold or transferred to another entity under common control, any difference between the consideration received and the aggregate book value of the assets and liabilities of the disposed of business is recorded as an adjustment to equity within the 'Capital contribution reserve'.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS **Year ended 31 December 2013**

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

j. Business combinations and disposals (continued)

ii) Combination of businesses under common control (continued)

Where the consideration for the transfer is received in the form of shares, these are recorded at the aggregate book value of the assets and liabilities disposed of.

k. Cash and cash equivalents

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

l. Income tax

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

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

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

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

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

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

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

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Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

m. Operating leases

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

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

n. Provisions

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

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the year end date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimate to settle the present obligation, its carrying amount is the present value of those cash flows.

o. Employee compensation plans

i) Equity-settled share-based compensation plans

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

ii) Other deferred compensation plans

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

p. Post-employment benefits

The Group operates defined contribution and defined benefit post-employment plans.

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

For the Group's defined benefit post-employment plans, the obligations of the plans are measured on an actuarial basis in accordance with the advice of an independent qualified actuary using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the plan liabilities. Plan assets are measured at their fair value at the reporting date. A surplus or deficit of plan assets over liabilities is recognised in the consolidated statement of financial position as an asset or a liability respectively. If the fair value of the plan assets is higher than the present value of the defined benefit obligation, the measurement of the resulting defined benefit asset is limited to the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan. The current service cost and any past service costs together with the net interest on the net defined benefit obligation/ asset is charged to 'Staff costs' within 'Other expense' in the consolidated income statement. Remeasurements that arise in calculating the Group's obligation in respect of a plan are recognised in other comprehensive income, in the period in which they occur.

Details of the plans are given in note 34 to these consolidated financial statements.

q. Offsetting of financial assets and financial liabilities

Where there is a currently legally enforceable right to set off the recognised amounts and an intention to either settle on a net basis or to realise the asset and the liability simultaneously, financial assets and financial liabilities are offset and the net amount is presented on the consolidated statement of financial position. In the absence of such conditions, financial assets and financial liabilities are presented on a gross basis.

4. NET GAINS ON AVAILABLE-FOR-SALE FINANCIAL ASSETS

	2013 \$millions	2012 \$millions
Dividend income	-	4
Net fair value gains reclassified from the available-for-sale reserve on disposal of assets	5	46
	<u>5</u>	<u>50</u>

5. 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 expense' (note 7).

No other gains or losses have been recognised in respect of financial liabilities at amortised cost other than as disclosed as 'Interest expense' within the consolidated income statement and foreign exchange differences disclosed in 'Other expense' (note 7).

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Year ended 31 December 2013

6. OTHER INCOME

	2013	2012
	\$millions	\$millions
Fee and commission income:		
Advisory fees	233	87
Non-UK capital gains tax recoverable	-	150
Trust and other fiduciary activities	170	130
Net foreign exchange gains	-	27
	<u>403</u>	<u>394</u>

Non-UK capital gains tax recoverable represents the expected reimbursement from clients on certain equity transactions. Contractually the clients are legally bound to reimburse the Group for any tax, levy, duty, charge, assessment or fee, directly or indirectly, in connection with or arising from these equity transactions. Such tax incurred by the Group in relation to these equity transactions is included in 'Income tax expense' within the consolidated income statement.

7. OTHER EXPENSE

	2013	2012
	\$millions	\$millions
Brokerage fees	497	463
Direct staff costs	195	187
Bank levy		
- Current year expense	46	36
- Prior year over provision	(6)	(10)
Operating lease rentals	9	10
Depreciation on property, plant and equipment	3	3
Net foreign exchange losses	13	-
Administration and corporate services	362	347
Auditor's remuneration:		
- Fees payable to the Company's auditor and its associates for the audit of the Company's annual financial statements	5	4
- Fees payable to the Company's auditor and its associates for other services to the Group*	1	1
Management charges from other Morgan Stanley Group undertakings relating to staff costs	1,861	1,469
Management charges from other Morgan Stanley Group undertakings relating to other services	329	474
Other	593	418
	<u>3,908</u>	<u>3,402</u>

*Fees payable to the Company's auditor for other services in 2013 comprise other assurance services of \$553,000 and tax compliance services of \$233,000 (2012: Other assurance services of \$315,000 and tax compliance services of \$200,000).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

7. OTHER EXPENSE (CONTINUED)

Included within both 'Direct staff costs' and 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' is an amount totalling \$192 million (2012: \$163 million) in relation to equity-settled share-based compensation plans, granted to employees of the Group. These costs reflect the amortisation of equity-based awards granted to employees over the last three years and are therefore not directly aligned with other staff costs in the current year. Also included within 'Direct staff costs' and 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' are amounts totalling \$68 million (2012: \$73 million) in relation to pension plans (see note 34).

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

	Number	
	Year ended 31 December 2013	Year ended 31 December 2012
Company and institutional securities infrastructure	139	152
Business units and other	167	206
	<u>306</u>	<u>358</u>

The cost of staff is analysed below:

	2013 \$millions	2012 \$millions
Wages and salaries	166	158
Social security costs	24	26
Pension costs	5	3
	<u>195</u>	<u>187</u>

The Group paid no remuneration to its Directors during the current or prior year but incurred management recharges in respect of Directors' services provided to the Group which are included within 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' within 'Other expense'. The amount of remuneration received by Directors in respect of their services to the Group is disclosed in note 35.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

8. INCOME TAX EXPENSE

	2013	2012
	\$millions	\$millions
Current tax expense		
United Kingdom corporation tax charge		
- current year	103	89
- adjustments in respect of prior years	(2)	(60)
Double taxation relief		
- current year	(81)	(49)
- adjustments in respect of prior years	1	7
Overseas tax		
- current year	128	146
- adjustments in respect of prior years	14	149
	<u>163</u>	<u>282</u>
Deferred tax expense		
Origination and reversal of temporary differences	(41)	(53)
Adjustment in respect of prior years	3	-
Effect of changes in tax rates	11	4
	<u>(27)</u>	<u>(49)</u>
Income tax expense	<u><u>136</u></u>	<u><u>233</u></u>

Reconciliation of effective tax rate

The current year income tax expense is higher (2012: higher) than that resulting from applying the average standard rate of corporation tax in the UK for the year of 23.25% (2012: 24.5%). The main differences are explained below:

	2013	2012
	\$millions	\$millions
Profit before income tax	<u>173</u>	<u>242</u>
Income tax using the average standard rate of corporation tax in the UK of 23.25% (2012: 24.5%)	40	59
Impact on tax of:		
Expenses not deductible for tax purposes:		
UK bank levy	9	6
Other expenses	5	2
Interest not deductible for tax purposes	-	2
Carry forward of prior years' tax losses	1	4
Group relief surrendered for no cash consideration	12	82
Net currency translation loss on disposal of subsidiaries	35	7
Effect of tax rates in foreign jurisdictions	16	119
Currency translation on tax	5	(1)
Tax exempt income	(1)	(12)
Tax under/ (over) provided in prior years	2	(55)
Recognition of tax reserves in respect of prior years	2	6
Other	10	14
Total income tax expense in the consolidated income statement	<u><u>136</u></u>	<u><u>233</u></u>

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8. INCOME TAX EXPENSE (CONTINUED)

The Group has a policy of surrendering tax-deductible losses ('group relief') for no cash consideration to other members of the Morgan Stanley UK tax group. A number of subsidiary companies within the Group generate tax-deductible losses which are surrendered to other Morgan Stanley undertakings outside the Group.

Finance Act 2012 enacted a reduction to the UK corporation tax rate to 23% with effect from April 2013. This reduction in the tax rate impacted the current tax charge in 2013. Finance Act 2013 received Royal Assent on 17 July 2013 and enacted a further reduction of the UK corporation tax rate to 21% with effect from 1 April 2014 and 20% with effect from 1 April 2015. These rate reductions will impact the current tax charge in 2014 and 2015.

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

	2013			2012		
	Before tax Smillions	Tax (expense)/ benefit Smillions	Net of tax Smillions	Before tax Smillions	Tax (expense)/ benefit Smillions	Net of tax Smillions
Remeasurement of net defined benefit liability	2	-	2	-	-	-
Foreign currency translation reserve:						
Foreign currency translation differences on foreign operations	35	-	35	24	-	24
Reclassification of foreign currency translation differences on disposal of foreign operations	151	-	151	30	-	30
Available-for-sale reserve:						
Net change in fair value of available-for-sale financial assets	5	(1)	4	30	(7)	23
Reclassification adjustments relating to available-for-sale assets disposed of during the year	(5)	1	(4)	(46)	11	(35)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	-	(2)	(2)	-	(3)	(3)
Other comprehensive income/(loss)	188	(2)	186	38	1	39

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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9. OTHER RECEIVABLES

	2013 \$millions	2012 \$millions
Amounts held at exchanges	452	403
Amounts due from other Morgan Stanley Group undertakings	2,336	5,139
Other amounts receivable	177	134
	<u>2,965</u>	<u>5,676</u>

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

Financial assets and financial liabilities classified as held for trading are summarised as follows:

	2013		2012	
	Assets \$millions	Liabilities \$millions	Assets \$millions	Liabilities \$millions
Government debt securities	9,703	8,805	18,153	17,009
Corporate and other debt	11,747	2,691	10,376	2,096
Corporate equities	44,680	17,833	30,505	16,673
Derivatives	<u>264,793</u>	<u>253,435</u>	<u>282,660</u>	<u>278,270</u>
	<u>330,923</u>	<u>282,764</u>	<u>341,694</u>	<u>314,048</u>

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

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

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

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

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

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

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

	2013		2012	
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
Prepaid OTC contracts	3,482	2,578	4,310	3,174
Corporate loans	1,882	-	1,117	-
Issued structured notes	-	1,150	-	1,390
Other financial assets and liabilities	2,309	9,395	2,164	7,996
	<u>7,673</u>	<u>13,123</u>	<u>7,591</u>	<u>12,560</u>

The maximum exposure to credit risk of loans or receivables which are designated at fair value through profit or loss as at 31 December 2013 is \$1,882 million (2012: \$1,117 million). The cumulative change in fair value of such loans or receivables attributable to changes in credit risk amounts to a loss of \$4 million (2012: loss of \$4 million) and the change for the current year is a gain of \$nil (2012: gain of \$1 million). This change is determined as the amount of change in fair value that is not attributable to the changes in market conditions that give rise to market risk.

The change in fair value recognised through the consolidated income statement attributable to own credit risk for financial liabilities designated at fair value during the year is a loss of \$50 million (2012: loss of \$187 million) and cumulatively is a gain of \$12 million (2012: gain of \$62 million). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to credit risk.

The carrying amount of financial liabilities designated at fair value was \$77 million higher than the contractual amount due at maturity (2012: \$59 million higher).

12. AVAILABLE-FOR-SALE FINANCIAL ASSETS

Financial assets that are classified as available-for-sale consist of corporate equities, of which \$2 million are listed investments (2012: \$2 million).

Movement in available-for-sale financial assets

	2013	2012
	\$millions	\$millions
Fair value		
At 1 January	40	67
Additions	27	2
Changes in fair value recognised in the available-for-sale reserve	5	30
Disposals and other settlements	(12)	(59)
At 31 December	<u>60</u>	<u>40</u>

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

13. INTERESTS IN SUBSIDIARIES

Composition of the Group

The Group consists of the Company and a number of subsidiaries, held directly and indirectly by the Company which operate and are incorporated around the world.

Details of the principal investments in subsidiaries of the Company at 31 December 2013 are listed below:

Name of Company	Country of incorporation	Type of shares held	Proportion of shares held by the Group ⁽¹⁾	Nature of business
Morgan Stanley Derivative Products (Netherlands) B.V.	Netherlands	Ordinary	100%	Financial services
Morgan Stanley Equity Derivative Services (Luxembourg) S.a.r.l.	Luxembourg	Ordinary	100%	Financial services
Morgan Stanley Equity Financing Limited	United Kingdom	Ordinary	100%	Financial services
Morgan Stanley Equity Investments (UK) Limited	Cayman Islands	Ordinary	100%	Financial services
Morgan Stanley Equity Trading (DIFC) Limited	United Arab Emirates	Ordinary	100%	Financial services
Morgan Stanley (France) SAS	France	Ordinary	100%	Financial services
Morgan Stanley Taiwan Limited	Republic of Taiwan	Ordinary	100%	Financial services
Morgan Stanley Tostao Limited	Cayman Islands	Ordinary	100%	Financial services

(1) The proportion of voting rights held by the Group is the same as the proportion of shares held by the Group unless otherwise stated.

During the year, there were no investments where the Group owned more than 50 per cent of the voting rights which were not classified as subsidiaries.

All subsidiaries are included in the Group's consolidated financial statements.

Except as disclosed below in "Disposal of subsidiaries", there were no changes in the Group's ownership interests in subsidiaries during 2013 (2012: none).

Information regarding interests in structured entities is included in note 14.

The Group has not provided, or otherwise agreed to be responsible for, supporting any subsidiary of the Group financially.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

13. INTERESTS IN SUBSIDIARIES (CONTINUED)

Disposal of subsidiaries

In January 2013 the Group restructured a subsidiary company, Morgan Stanley Derivative Products (Luxembourg) S.à r.l. ("MSDP") and disposed of MSDP together with five other wholly owned subsidiaries to another Morgan Stanley Group undertaking outside of the Group.

During 2012, the Group disposed of two wholly owned subsidiaries, Morgan Stanley Euro Financing (Luxembourg) and Morgan Stanley Moselle S.à r.l. to another Morgan Stanley Group undertaking.

The subsidiaries that were disposed of during the year and the prior year were non-US dollar functional currency entities. The subsidiaries were sold for consideration equal to their net book value, however, as a consequence of the sale, accumulated foreign currency translation losses amounting to \$151 million (2012: \$30 million) were reclassified from the "Currency translation reserve" to the consolidated income statement within "Net currency translation loss on disposal of subsidiaries". This reclassification did not have an impact on the net assets of the Group.

The carrying value of the net assets of these subsidiaries at the date of disposal was as follows:

	2013 At disposal \$millions	2012 At disposal \$millions
ASSETS		
Trade receivables	1,899	1,920
Financial assets classified as held for trading	1,840	-
TOTAL ASSETS	3,739	1,920
LIABILITIES		
Other payables	1,901	-
Financial liabilities classified as held for trading	3	-
TOTAL LIABILITIES	1,904	-
NET ASSETS	1,835	1,920
Total consideration received	1,835	1,920
Reclassification of net cumulative translation losses	151	30
Loss on disposal	151	30
Total consideration received in cash	1,835	1,920
Less cash and cash equivalents in subsidiary disposed of	-	-
Net cash inflow arising on disposal	1,835	1,920

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14. INTERESTS IN STRUCTURED ENTITIES

The Group is involved with various special purpose entities ("SPE") in the normal course of business. In most cases, these entities are deemed to be structured entities.

A structured entity is an entity that has been designed such that voting or similar rights are not the dominant factor in deciding who controls the entity. The party that consolidates the structured entity is the investor that controls the structured entity. An investor controls a structured entity when it is exposed, or has the rights, to variable returns from its involvement with the structured entity and has the ability to affect those returns through its power over the structured entity. The Group consolidates structured entities it controls.

The Group's interests in structured entities include certain debt and equity interests, commitments, guarantees, derivative instruments and certain fees arrangements. The Group's involvement with structured entities arises primarily from:

- Loans made to and investments in structured entities that hold debt, equity, real estate or other assets;
- Interests purchased in connection with market-making activities and retained interests held as a result of securitisation activities;
- Structuring of asset-repackaged notes designed to meet the investment objectives of clients;
- Certain derivatives entered into with structured entities.

The Group determines whether it controls, and therefore should consolidate, a structured entity upon its initial involvement with the structured entity and reassesses whether it should continue to consolidate on an ongoing basis as long as it has any continuing involvement with the structured entity. This determination is based upon an analysis of the design of the structured entity, including the entity's structure and activities; assessment of the significance of the powers to make economic decisions which are held by the Group and its related parties and whether such powers may be used to affect its investor returns; and consideration of the significance of direct and indirect interests in the structured entity which are held by the Group and its related parties.

The power to make the most significant economic decisions may take a number of different forms. The Group considers servicing or collateral management decisions as generally representing the power to make the most significant economic decisions in transactions such as securitisations or collateralised debt obligations ("CDOs"). As a result, the Group does not consolidate securitisations or CDOs for which it does not act as the servicer or collateral manager unless it holds certain other rights to replace the servicer or collateral manager or to require the liquidation of the entity. In fund structures, the power to appoint or direct the fund manager is generally the most significant power.

For certain structured entities, such as entities which issued Credit Linked Notes ('CLNs') and other asset-repackaged notes, there are no significant economic decisions made on an ongoing basis. In these cases, the Group focuses its analysis on decision making powers relating to liquidation of the entity or unwinding or termination of the transaction structure. Based upon factors, which include an analysis of the nature of the assets, including whether the assets were issued in a transaction sponsored by the Group and the extent of the information available to the Group and to investors, the number, nature and involvement of investors, other rights held by the Group and investors, the standardisation of the legal documentation and the level of the continuing involvement by the Group, including the amount and type of interests owned by the Group and by other investors, the Group concluded in some of these transactions that decisions made prior to the initial closing were shared between the Group and the initial investors. The Group focused its control decision on any right held by the Group or investors related to the termination of the structured entity. Many CLNs and other asset repackaged notes have no such termination rights.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

14. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

The assets owned by many consolidated structured entities cannot be removed unilaterally by the Group and are not generally available to the Group. The related liabilities issued by many consolidated structured entities are non-recourse to the Group. In certain other consolidated structured entities, the Group has the unilateral right to remove assets or provide additional recourse through derivatives such as total return swaps, guarantees or other forms of involvement.

The Group accounts for the assets held by structured entities primarily in 'Financial assets classified as held for trading – corporate and other debt' and the liabilities of the structured entities as 'Financial liabilities designated at fair value' in the consolidated statement of financial position.

The usage of structured entities is described below.

Securitisation Activities. In a securitisation transaction, the Group transfers assets (generally commercial or residential mortgage loans) to a structured entity, sells to investors most of the beneficial interests, such as notes or certificates, issued by the structured entity, and in many cases, retains other beneficial interests. The purchase of the transferred assets by the structured entity is financed through the sale of these interests. In many securitisations, particularly those involving residential mortgage loans, the Group also enters into derivative transactions, primarily interest rate swaps or interest rate caps with a senior payment priority, with the structured entity.

Credit Protection Purchased through CLNs. In a CLN transaction, the Group transfers reference assets (generally high-quality securities or money market investments) to a structured entity, enters into a derivative transaction in which the structured entity writes protection on an unrelated reference asset or group of assets, through a credit default swap, a total return swap or similar instrument, and sells to investors the securities issued by the structured entity. In some transactions, the Group may also enter into interest rate or currency swaps with the structured entity. The purchase of the transferred assets by the structured entity is financed through the sale of the securities issued. Upon the occurrence of a credit event related to the reference asset, the structured entity will deliver collateral securities as the payment to the Group. The Group is generally exposed to price changes on the collateral securities in the event of a credit event and subsequent sale. These transactions are designed to provide investors with exposure to certain credit risk on the reference asset. The structure of the transaction determines the accounting treatment. In some transactions, the assets and liabilities of the structured entity are recognised in the Group's consolidated financial statements. In other transactions, the transfer of the collateral securities is accounted for as a sale of assets, and the structured entity is not consolidated. *Collateralised Loan and Debt Obligations.* A collateralised loan obligation ("CLO") or a CDO is a structured entity that purchases a pool of assets, consisting of corporate loans, corporate bonds, asset-backed securities or synthetic exposures on similar assets through derivatives, and issues multiple tranches of debt and equity securities to investors. The purchase of the assets by the structured entity is financed through the issuance of the tranches of securities. The Group underwrites the securities issued in CLO transactions on behalf of unaffiliated sponsors and provides advisory services to these unaffiliated sponsors. The Group sells corporate loans to many of these structured entities, in some cases representing a significant portion of the total assets purchased. If necessary, the Group may retain unsold securities issued in these transactions. Although not obligated, the Group generally makes a market in the securities issued by structured entities in these transactions. These beneficial interests are included in Financial assets classified as held for trading.

Equity-Linked Notes. In an equity-linked note transaction the Group typically transfers to a structured entity either a note issued by the Group, the payments on which are linked to the performance of a specific equity security, equity index or other index, or debt securities issued by other companies and a derivative contract, the terms of which will relate to the performance of a specific equity security, equity index or other index. These transactions are designed to provide investors with exposure to certain risks related to the specific equity security, equity index or other index.

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14. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

The purchase of the transferred note or debt securities by the structured entity is financed through the sale of equity interests to investors. Equity-linked notes are included in "Other" in the tables below.

Fund Investments. In a fund investment structure the Group provides clients with indirect access to specified underlying investments through total return swaps. The investments are purchased and held by a structured entity in which the Group holds an interest. The structured entity is financed through the sale of notes to investors.

Consolidated structured entities

The table below shows information about the structured entities the Group consolidates. Consolidated structured entity assets and liabilities are presented after intercompany eliminations and include assets financed on a non-recourse basis:

	Mortgage and asset-backed securitisations \$millions	Credit linked notes \$millions	Fund investments \$millions	Other \$millions	Total \$millions
31 December 2013					
Structured entity assets	-	173	311	5	489
Structured entity liabilities	-	170	-	5	175
31 December 2012					
Structured entity assets	233	271	-	2	506
Structured entity liabilities	192	252	-	-	444

In general, the Group's exposure to loss in consolidated structured entities is limited to losses that would be absorbed by the structured entity's assets recognised in its financial statements, net of losses absorbed by third-party holders of the structured entity's liabilities. The Group also had additional maximum exposure to losses of approximately \$nil and \$2 million at 31 December 2013 and 31 December 2012, respectively. This additional exposure related primarily to certain derivatives (e.g., instead of purchasing senior securities, the Group has sold credit protection to synthetic CDOs through credit derivatives that are typically related to the most senior tranche of the CDO) and commitments, guarantees and other forms of involvement.

The Group has not provided financial support or otherwise agreed to be responsible for, supporting any consolidated structured entity financially.

Unconsolidated structured entities

The Group has interests in structured entities that the Group does not control and are therefore not consolidated.

The Group's transactions with unconsolidated structured entities primarily include securitisations, credit protection purchased through CLNs, other structured financings and collateralised loan and debt obligations. The Group's interests in structured entities that it does not consolidate can include ownership of retained interests in Group-sponsored transactions, interests purchased in the secondary market (both for Group-sponsored transactions and transactions sponsored by third parties), and certain derivatives with securitisation structured entities. The risks associated with derivatives entered into with structured entities are essentially the same as similar derivatives with non-structured entity counterparties and are managed as part of the Group's overall exposure.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

14. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

The tables below shows certain non-consolidated structured entities in which the Group had an interest at 31 December 2013 and at 31 December 2012. The tables include all structured entities in which the Group has determined that its maximum exposure to loss is greater than specific thresholds or meets certain other criteria. Most of the structured entities included in the tables below are sponsored by unrelated parties; the Group's involvement generally is the result of the Group's secondary market-making activities.

	Mortgage and asset-backed securitisations Smillions	Collateralised debt obligations Smillions	Fund investments Smillions	Other Smillions	Total Smillions
31 December 2013					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	13,819	3,304	2,559	144	19,826
Maximum exposure to loss:					
Debt and equity interests	620	243	-	49	912
Derivative and other contracts	-	-	2,559	39	2,598
Total maximum exposure to loss	620	243	2,559	88	3,510
Carrying value of exposure to loss - assets:					
Debt and equity interests ⁽¹⁾	620	243	-	49	912
Derivative and other contracts	-	-	-	-	-
Total carrying value of exposure to loss - assets	620	243	-	49	912
Carrying value of exposure to loss - liabilities:					
Derivative and other contracts ⁽¹⁾	-	-	6	1	7
Total carrying value of exposure to loss - liabilities	-	-	6	1	7

(1) Amounts are recognised in the consolidated statement of financial position in financial assets or liabilities classified as held for trading – derivatives or financial assets or liabilities classified as held for trading – corporate and other debt.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

14. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

	Mortgage and asset-backed securitisations Smillions	Collateralised debt obligations Smillions	Fund investments Smillions	Other Smillions	Total Smillions
31 December 2012					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	8,197	899	1,559	217	10,872
Maximum exposure to loss:					
Debt and equity interests	488	49	-	39	576
Derivative and other contracts	-	-	1,559	87	1,646
Total maximum exposure to loss	488	49	1,559	126	2,222
Carrying value of exposure to loss - assets:					
Debt and equity interests ⁽¹⁾	488	49	-	33	570
Derivative and other contracts	-	-	3	2	5
Total carrying value of exposure to loss - assets	488	49	3	35	575
Carrying value of exposure to loss - liabilities:					
Derivative and other contracts ⁽¹⁾	-	-	-	-	-
Total carrying value of exposure to loss - liabilities	-	-	-	-	-

(1) Amounts are recognised in the consolidated statement of financial position in financial assets or liabilities classified as held for trading – derivatives or financial assets or liabilities classified as held for trading – corporate and other debt.

The Group's maximum exposure to loss often differs from the carrying value of the interests held by the Group. The maximum exposure to loss is dependent on the nature of the Group's interest in the structured entities and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Group has made in the structured entities. Liabilities issued by structured entities generally are non-recourse to the Group. Where notional amounts are utilised in quantifying maximum exposure related to derivatives, such amounts do not reflect fair value write downs already recorded by the Group.

The Group's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Group may utilise to hedge these risks associated with the Group's interests. In addition, the Group's maximum exposure to loss is not reduced by the amount of collateral held as part of a transaction with the structured entity or any party to the structured entity directly against a specific exposure to loss.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

14. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

Securitisation transactions generally involve structured entities. Primarily as a result of its secondary market-making activities, the Group owned additional securities issued by securitisation structured entities for which the maximum exposure to loss is less than specific thresholds. These additional securities totalled \$542 million at 31 December 2013 (2012: \$409 million). These securities were retained in connection with transfers of assets by the Group. Securities issued by securitisation structured entities consist of \$244 million of securities backed primarily by residential mortgage loans (2012: \$210 million), \$160 million of securities backed by commercial mortgage loans (2012: \$55 million), \$137 million of securities backed by collateralised debt obligations or collateralised loan obligations (2012: \$125 million) and \$1 million backed by other consumer loans (2012: \$19 million). The Group's primary risk exposure is to the securities issued by the structured entity owned by the Group, with the risk being highest on the most subordinate class of beneficial interests. These securities generally are included in Financial assets classified as held for trading – corporate and other debt. The Group does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees or similar derivatives. The Group's maximum exposure to loss generally equals the fair value of the securities owned.

The Group has not provided, or otherwise agreed to be responsible for, supporting any unconsolidated structured entity financially.

Sponsored unconsolidated structured entities

The Group considers itself the sponsor of certain non-consolidated structured entities where it was primarily involved in the establishment of a structured entity and additionally where the Group has been involved in the transfer of assets; servicer of the assets; ability to access the assets; marketing; managing activities; purchasing protection or providing explicit guarantees; when Morgan Stanley's name is associated with the structured entity or where market participants may generally expect Morgan Stanley to be associated with the structured entity.

For some sponsored entities, the Group has no interest at 31 December 2013, however the Group has been involved with the structured entity through establishing the structured entity, marketing of products associated with the structured entity in its own name, and/or through involvement in the design of the structured entity.

The loss incurred related to sponsored entities issuing equity linked notes during 2013 was \$76 million (2012: gain of \$49 million). (Losses)/gains are reported under 'Net gains on financial instruments classified as held for trading' in the consolidated income statement. No assets were transferred to the structured entities during 2013 (2012: \$nil).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

15. PROPERTY, PLANT AND EQUIPMENT

2013

	Leasehold improvements \$millions	Fixtures, fittings and equipment \$millions	Total \$millions
Cost			
At 1 January 2013	24	24	48
Additions	1	-	1
Foreign exchange revaluation	-	1	1
Disposals	-	(2)	(2)
At 31 December 2013	<u>25</u>	<u>23</u>	<u>48</u>
Depreciation			
At 1 January 2013	21	20	41
Charge for the year	2	1	3
Foreign exchange revaluation	-	1	1
Disposals	-	(2)	(2)
At 31 December 2013	<u>23</u>	<u>20</u>	<u>43</u>
Carrying amount			
At 31 December 2013	<u>2</u>	<u>3</u>	<u>5</u>

2012

	Leasehold improvements \$millions	Fixtures, fittings and equipment \$millions	Total \$millions
Cost			
At 1 January 2012	23	23	46
Additions	-	1	1
Foreign exchange revaluation	1	1	2
Disposals	-	(1)	(1)
At 31 December 2012	<u>24</u>	<u>24</u>	<u>48</u>
Depreciation			
At 1 January 2012	18	18	36
Charge for the year	2	1	3
Foreign exchange revaluation	1	1	2
At 31 December 2012	<u>21</u>	<u>20</u>	<u>41</u>
Carrying amount			
At 31 December 2012	<u>3</u>	<u>4</u>	<u>7</u>

There was no impairment identified in 2013 (2012: \$nil).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

16. SUBORDINATED LOANS

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

Counterparty	Repayment Date	Interest Rate	2013 \$millions	2012 \$millions
Morgan Stanley UK Financing I LP	31 October 2025	LIBOR ⁽¹⁾ plus 1.475%	7,906	7,906

(1) London Interbank Offered Rate ("LIBOR")

The amount outstanding under the subordinated loan agreement is repayable at any time at the Group's option, subject to two business days' notice to the lender and at least one month's notice to the PRA.

On 11 December 2013 the interest rate on the agreement was amended from LIBOR plus 1.25% to LIBOR plus 1.475%.

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

17. OTHER PAYABLES

	2013 \$millions	2012 \$millions
Amounts due to other Morgan Stanley Group undertakings	15,807	17,506
Other amounts payable	2,372	110
	<u>18,179</u>	<u>17,616</u>

18. PROVISIONS

	Property \$millions	Litigation \$millions	Other \$millions	Total \$millions
At 1 January 2013	3	79	-	82
Additional provisions	1	-	25	26
Provisions utilised	-	(78)	-	(78)
At 31 December 2013	<u>4</u>	<u>1</u>	<u>25</u>	<u>30</u>

Property

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Property, plant and equipment' (note 15).

Litigation matters

In addition to the matters described below, in the normal course of business, the Group has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

18. PROVISIONS (CONTINUED)

Litigation matters (continued)

The Group is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and regulatory bodies regarding the Group's business, and involving, among other matters, sales and trading activities, financial products or offerings sponsored, underwritten or sold by the Group, and accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

The Group contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the financial statements and the Group can reasonably estimate the amount of that loss, the Group accrues the estimated loss by a charge to the profit and loss account. The Group expects future litigation accruals in general to continue to be elevated and the changes in accruals from period to period may fluctuate significantly, given the current environment regarding government investigations and private litigation affecting global financial services firms, including the Group.

For certain legal proceedings, the Group cannot predict with certainty if, how or when such proceedings or investigations will be resolved or what the eventual settlement, fine, penalty or other relief, if any, may be, particularly for proceedings and investigations where the factual record is being developed or contested or where plaintiffs or government entities seek substantial or indeterminate damages, restitution, disgorgement or penalties. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages or other relief, and by addressing novel or unsettled legal questions relevant to the proceedings or investigations in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for a proceeding or investigation.

For certain other legal proceedings, the Group can estimate reasonably possible losses, additional losses, ranges of loss or ranges of additional loss in excess of amounts accrued, but does not believe, based on current knowledge and after consultation with counsel, that such losses will have a material adverse effect on the Group's consolidated financial statements as a whole, although the outcome of such proceedings could be material to the Group's operating results and cash flows for a particular period depending on, among other things, the level of the Group's revenues or income for such period.

Over the last several years, the level of litigation and investigatory activity (both formal and informal) by government and regulatory bodies has increased materially in the financial services industry. As a result, the Group expects that it may become the subject of increased claims for damages and other relief and, while the Group has identified below certain proceedings that the Group believes to be material, individually or collectively, there can be no assurance that additional material losses will not be incurred from claims that have not yet been asserted or are not yet determined to be material.

On 25 August 2008, the Morgan Stanley Group, the Group and two ratings agencies were named as defendants in a purported class action related to securities issued by a structured investment vehicle ("SIV") called Cheyne Finance plc and Cheyne Finance LLC (together, the "Cheyne SIV"). The case is styled *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.* and is pending in the United States District Court for the Southern District of New York ("SDNY"). The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. The plaintiffs currently assert allegations of aiding and abetting fraud and negligent misrepresentation relating to approximately \$852 million of securities issued by the Cheyne SIV. The plaintiffs' motion for class certification was denied in June 2010. The court denied the Morgan Stanley Group's and the Group's motion for summary judgment on the aiding and abetting fraud claim in August 2012. On 30 November 2012, the Morgan Stanley Group and the Group filed a motion for summary judgment on the negligent misrepresentation claim.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

18. PROVISIONS (CONTINUED)

Litigation matters (continued)

On 24 April 2013, the Morgan Stanley Group and the Group reached an agreement to settle this matter. On 26 April 2013, the court dismissed the action with prejudice. The settlement does not cover certain claims that were previously dismissed. On 23 May 2013, certain parties in *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.* filed a notice of appeal as to certain claims dismissed from the matter prior to the settlement by the remaining parties.

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Group and another Morgan Stanley Group undertaking, which is styled *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated* and is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a \$275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Group misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Group knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately \$228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional \$12 million, punitive damages, equitable relief, fees and costs. On 10 March 2011, the Group and another Morgan Stanley Group undertaking filed its answer to the complaint.

On 25 October 2010, the Group, other Morgan Stanley Group undertakings and Pinnacle Performance Limited, a special purpose vehicle ("SPV"), were named as defendants in a purported class action related to securities issued by the SPV in Singapore, commonly referred to as Pinnacle Notes. The case is styled *Ge Dandong, et al. v. Pinnacle Performance Ltd., et al.* and is pending in the Southern District of New York ("SDNY"). An amended complaint was filed on 22 October 2012. The court denied defendants' motion to dismiss the amended complaint on 22 August 2013 and granted class certification on 17 October 2013. On 30 October 2013, defendants filed a petition for permission to appeal the court's decision granting class certification. On 31 January 2014, plaintiffs filed a second amended complaint. The second amended complaint alleges that the defendants engaged in a fraudulent scheme to defraud investors by structuring the Pinnacle Notes to fail and benefited subsequently from the securities' failure. In addition, the second amended complaint alleges that the securities' offering materials contained material misstatements or omissions regarding the securities' underlying assets and the alleged conflicts of interest between the defendants and the investors. The second amended complaint asserts common law claims of fraud, aiding and abetting fraud, fraudulent inducement, aiding and abetting fraudulent inducement, and breach of the implied covenant of good faith and fair dealing. Plaintiffs seek damages of approximately \$138.7 million, rescission, punitive damages, and interest.

On 1 July 2013, the European Commission ("EC") issued a Statement of Objections ("SO") addressed to twelve financial firms (including the Group), the International Swaps and Derivatives Association, Inc. ("ISDA") and Markit Group Limited ("Markit") and various other Morgan Stanley Group undertakings alleging that, between 2006 and 2009, the recipients breached EU competition law by taking and refusing to take certain actions in an effort to prevent the development of exchange traded CDS products. The SO indicates that the EC plans to impose remedial measures and fines on the recipients. The Group, other Morgan Stanley Group undertakings and the other recipients filed a response to the SO on 21 January 2014. A Morgan Stanley Group undertaking and others have also responded to an investigation by the Antitrust Division of the United States Department of Justice related to the CDS market.

Other

Other includes a provision for foreign withholding taxes that the Group may be required to settle on behalf of clients in relation to certain stock loan transactions. The amount of the provision reflects the most likely estimate within an identified range of possible outcomes.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

19. DEFERRED TAX ASSETS AND LIABILITIES

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

	2013		2012	
	Deferred tax asset Smillions	Deferred tax liability Smillions	Deferred tax asset Smillions	Deferred tax liability Smillions
At 1 January	91	(4)	44	(7)
Amount recognised in the consolidated income statement	37	1	53	-
Amount recognised in other comprehensive income	(2)	-	(2)	4
Impact of changes in tax rates recognised in the consolidated income statement	(11)	-	(4)	-
Impact of changes in tax rates recognised in other comprehensive income	(1)	-	(1)	-
Foreign exchange adjustment	1	-	1	(1)
At 31 December	<u>115</u>	<u>(3)</u>	<u>91</u>	<u>(4)</u>

For the purpose of presentation in the consolidated statement of financial position, certain deferred tax assets and liabilities have been offset. The deferred tax included in the consolidated statement of financial position and changes recorded in 'Income tax expense' are as follows:

	Deferred tax asset 2013 Smillions	Deferred tax liability 2013 Smillions	Consolidated income statement 2013 Smillions	Deferred tax asset 2012 Smillions	Deferred tax liability 2012 Smillions	Consolidated income statement 2012 Smillions
Depreciation - temporary differences	4	-	-	5	-	1
Deferred compensation	23	-	2	25	-	4
Available-for-sale financial assets	-	(1)	-	-	(1)	-
Tax losses carried forward	22	-	(22)	-	-	-
Forecast currency hedges	-	(2)	(1)	-	(3)	(1)
Amounts not recognised due to unobservable market data	5	-	-	8	-	-
Deferred interest	56	-	4	45	-	(45)
Other temporary differences	5	-	(10)	8	-	(8)
	<u>115</u>	<u>(3)</u>	<u>(27)</u>	<u>91</u>	<u>(4)</u>	<u>(49)</u>

Finance Act 2013 enacted a reduction to the UK corporation tax rate to 21% with effect from April 2014 and 20% with effect from 1 April 2015. This overall rate reduction to 20% has had an impact on the Group's deferred tax balance as indicated above.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

19. DEFERRED TAX ASSETS AND LIABILITIES (CONTINUED)

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

Deferred tax assets have not been recognised in respect of the following items (amounts shown are as at the end of the reporting period):

	2013 \$millions	2012 \$millions
Unused tax losses	8	38

The aggregate amount of temporary differences associated with investments in subsidiaries and branches for which deferred tax liabilities have not been recognised is \$nil (2012: \$nil).

20. COMMITMENTS AND CONTINGENCIES

Leases

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

	2013 \$millions	2012 \$millions
Lease payments under non-cancellable operating leases recognised as an expense in the year		
- Minimum lease payments	9	10

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

	2013 \$millions	2012 \$millions
Within one year	8	8
In two to five years	21	23
Over five years	9	13
	38	44

Contingent liability relating to tax

The tax position of a subsidiary undertaking of the Group is currently under review by the Dutch tax authorities. The review has not progressed sufficiently to determine the timings of resolution or the amount of any outflow. The current estimate of the maximum amount payable, if any, arising from this review is \$171 million.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

20. COMMITMENTS AND CONTINGENCIES (CONTINUED)

Other commitments and contingent liabilities

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

Contingent liabilities

	2013 \$millions	2012 \$millions
Forward starting reverse repurchase agreements	23,857	25,370
Letters of credit	1	5
	<u>23,858</u>	<u>25,375</u>

Commitments

	2013 \$millions	2012 \$millions
Loan commitments	1,870	985
Contingent commitments	821	2,172
Undersubscriptions commitments	588	44
	<u>3,279</u>	<u>3,201</u>

21. EQUITY

	Ordinary shares of \$1 each \$millions	Ordinary shares of £1 each \$millions	Class A ordinary shares of \$1 each \$millions	Class C, non- cumulative, preference shares of \$1 each \$millions	Class D1, non- cumulative, preference shares of \$0.4 each \$millions	Total shares \$millions
Issued and fully paid:						
At 1 January 2012	6,884	30	1,500	50	1,000	9,464
At 31 December 2012	<u>6,884</u>	<u>30</u>	<u>1,500</u>	<u>50</u>	<u>1,000</u>	<u>9,464</u>
At 1 January 2013	6,884	30	1,500	50	1,000	9,464
Issued / (repurchased) in the year:						
Ordinary shares of \$1 each issued	3,050	-	-	-	-	3,050
Non-cumulative, preference shares repurchased	-	-	-	(50)	(1,000)	(1,050)
At 31 December 2013	<u>9,934</u>	<u>30</u>	<u>1,500</u>	<u>-</u>	<u>-</u>	<u>11,464</u>
Voting rights at 31 December 2013	<u>99.7%⁽¹⁾</u>	<u>0.3%⁽¹⁾</u>	<u>Non-voting</u>	<u>-</u>	<u>-</u>	<u>100%</u>

(1) Ordinary shares are pari passu with each other regardless of currency and together carry 100% of the vote (2012: 70%)

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

21. EQUITY (CONTINUED)

During December 2013 the Company entered into the following transactions:

- On 12 December 2013 1,050,000,000 ordinary shares of \$1 each were issued at par to the Company's immediate parent undertaking pursuant to a Share Purchase and Buy Back Agreement. The proceeds were used to buy back and cancel all of the Company's Class C and Class D1 non-redeemable non-cumulative preference shares.
- On 18 December 2013, 2,000,000,000 ordinary shares of \$1 each were issued at par, to the Company's immediate parent undertaking for cash consideration.

Equity shares

At 31 December 2013 the total issued share capital equated to \$11,464 million (2012: \$9,464 million) comprising of 9,934,105,148 (2012: 6,884,105,148) ordinary shares of \$1 each, 17,615,107 (2012: 17,615,107) ordinary shares of £1 each and 1,500,000,000 (2012: 1,500,000,000) Class A Non-voting ordinary shares of \$1 each. All issued shares are fully paid. At 31 December 2012 the total share capital also included 50,000,000 Class C non-redeemable non-cumulative preference shares of \$1 each and 2,500,000,000 Class D1 non-cumulative voting preference shares of \$0.4 each.

The holders of the 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. All shares rank equally with regard to the Company's residual assets, except that preference shareholders participate only to the extent of the nominal value of the shares plus any accrued dividends.

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

Reserves

Share premium

The 'Share premium account' comprises the capital raised in an issue of shares that exceeds the nominal value of the shares.

Currency translation reserve

The 'Currency translation reserve' comprises all foreign exchange differences arising from the translation of the total assets less total liabilities of foreign operations. The tax effect of these movements is also included in the 'currency translation reserve'.

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

During the year, the Group disposed of Morgan Stanley Derivative Products (Luxembourg) S.à r.l with five wholly owned subsidiaries, which were non-US dollar functional entities, to other Morgan Stanley Group undertakings. A consequence of these disposals was that accumulated foreign exchange losses totalling \$151 million were reclassified from the 'currency translation reserve' to the consolidated income statement.

Available-for-sale reserve

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

Capital contribution reserve

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

21. EQUITY (CONTINUED)

Reserves (continued)

Capital redemption reserve

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

22. DIVIDENDS

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

	2013		2012	
	Per share \$	Total \$millions	Per share \$	Total \$millions
Dividends on Class C preference shares	0.020	1	0.014	1
Dividends on Class D1 preference shares	0.035	88	-	-
		<u>89</u>		<u>1</u>

The Class C preference share dividend was paid in December 2013 and the Class D1 preference share dividend was paid in January 2014.

The Directors have not proposed the payment of a final dividend out of reserves available at 31 December 2013 (2012: \$nil).

23. ADDITIONAL CASH FLOW INFORMATION

a. Cash and cash equivalents

For the purposes of the consolidated statement of cash flows, cash and cash equivalents comprise the following balances, which have less than three months maturity from the date of acquisition:

	2013 \$millions	2012 \$millions
Cash and short-term deposits	12,244	11,526
Bank loans and overdrafts	<u>(16)</u>	<u>(23)</u>
	<u>12,228</u>	<u>11,503</u>

Included within 'Cash and short term deposits' is \$8,267 million (2012: \$7,480 million) of segregated client money, held in accordance with the FCA's Client Money Rules, and an amount of \$386 million (2012: \$334 million) which represents other client money, that is not available for use by the Group. The corresponding payable is recognised and included in 'Trade payables' within 'Financial liabilities at amortised cost'.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2013

23. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)

b. Reconciliation of cash flows from operating activities

	Note	2013 \$millions	2012 \$millions
Profit for the year		37	9
<i>Adjustments for:</i>			
Net gains on available-for-sale financial assets	4	(5)	(50)
Non-UK capital gains tax recoverable	6	-	(150)
Depreciation on property, plant and equipment	15	3	3
Interest income (restated)*		(1,217)	(1,513)
Interest expense (restated)*		1,610	1,950
Income tax expense	8	136	233
Net currency translation loss on disposal of subsidiaries	13	151	30
Operating cash flows before changes in operating assets and liabilities		<u>715</u>	<u>512</u>
Changes in operating assets			
Decrease/(increase) in loans and receivables, excluding cash and short term deposits (restated)*		21,400	(3,495)
Decrease in financial assets classified as held for trading		10,770	12,449
(Increase)/decrease in financial assets designated at fair value through profit or loss		(82)	971
		<u>32,088</u>	<u>9,925</u>
Changes in operating liabilities			
(Decrease)/increase in financial liabilities at amortised cost, excluding bank loans and overdrafts (restated)*		(4,430)	7,266
Decrease in financial liabilities classified as held for trading		(31,284)	(19,777)
Increase in financial liabilities designated at fair value through profit or loss		563	850
(Decrease)/increase in provisions		(53)	72
		<u>(35,204)</u>	<u>(11,589)</u>
Interest received (restated)*		1,348	1,406
Interest paid (restated)*		(1,770)	(1,653)
Income taxes paid		(183)	(24)
Effect of foreign exchange movements		(20)	(96)
Net cash flows used in operating activities		<u>(3,026)</u>	<u>(1,519)</u>

*Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

24. 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 2013

	Less than or equal to twelve months \$millions	More than twelve months \$millions	Total \$millions
ASSETS			
Loans and receivables:			
Cash and short term deposits	12,244	-	12,244
Cash collateral on securities borrowed	17,372	-	17,372
Securities purchased under agreements to resell	75,697	20	75,717
Trade receivables	72,220	-	72,220
Other receivables	2,513	452	2,965
	180,046	472	180,518
Financial assets classified as held for trading	330,923	-	330,923
Financial assets designated at fair value through profit or loss	7,439	234	7,673
Available-for-sale financial assets	-	60	60
Current tax assets	229	-	229
Deferred tax assets	-	115	115
Prepayments and accrued income	43	-	43
Property, plant and equipment	-	5	5
	518,680	886	519,566
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	16	-	16
Cash collateral on securities loaned	13,457	-	13,457
Securities sold under agreements to repurchase	67,870	2,146	70,016
Trade payables	97,946	-	97,946
Subordinated loans	-	7,906	7,906
Other payables	14,978	3,201	18,179
	194,267	13,253	207,520
Financial liabilities classified as held for trading	282,764	-	282,764
Financial liabilities designated at fair value through profit or loss	10,095	3,028	13,123
Provisions	27	3	30
Current tax liabilities	242	-	242
Deferred tax liabilities	-	3	3
Accruals and deferred income	221	-	221
Post-employment benefit obligations	-	4	4
	487,616	16,291	503,907

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2013

24. EXPECTED MATURITY OF ASSETS AND LIABILITIES (CONTINUED)

At 31 December 2012

	Less than or equal to twelve months \$millions	More than twelve months \$millions	Total \$millions
ASSETS			
Loans and receivables:			
Cash and short term deposits	11,526	-	11,526
Cash collateral on securities borrowed (restated)*	19,733	-	19,733
Securities purchased under agreements to resell	99,403	379	99,782
Trade receivables	66,438	-	66,438
Other receivables	5,273	403	5,676
	<u>202,373</u>	<u>782</u>	<u>203,155</u>
Financial assets classified as held for trading	341,694	-	341,694
Financial assets designated at fair value through profit or loss	3,644	3,947	7,591
Available-for-sale financial assets	-	40	40
Current tax assets	210	-	210
Deferred tax assets	-	91	91
Prepayments and accrued income	53	-	53
Property, plant and equipment	-	7	7
	<u>547,974</u>	<u>4,867</u>	<u>552,841</u>
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	23	-	23
Cash collateral on securities loaned (restated)*	17,462	304	17,766
Securities sold under agreements to repurchase	81,673	4,021	85,694
Trade payables	83,161	-	83,161
Subordinated loans	-	7,906	7,906
Other payables	14,393	3,223	17,616
	<u>196,712</u>	<u>15,454</u>	<u>212,166</u>
Financial liabilities classified as held for trading	314,048	-	314,048
Financial liabilities designated at fair value through profit or loss	8,725	3,835	12,560
Provisions	82	-	82
Current tax liabilities	243	-	243
Deferred tax liabilities	-	4	4
Accruals and deferred income	208	-	208
Post-employment benefit obligations	-	5	5
	<u>520,018</u>	<u>19,298</u>	<u>539,316</u>

*Details of the restatement are provided in note 2.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

25. SEGMENT REPORTING

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

Business segments

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

The Group has two reportable business segments being Institutional Securities and Investment Management. Institutional Securities include the following activities: financial advisory and capital raising services; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities. Investment Management activities include a broad array of investment strategies that span the risk/ return spectrum across geographies, asset classes and public and private markets to a diverse group of clients across the institutional and intermediary channels as well as high net worth clients.

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

2013	Institutional securities \$millions	Investment management \$millions	Total \$millions
Consolidated income statement information:			
Net gains on financial instruments classified as held for trading	4,082	-	4,082
Net gains on financial instruments designated at fair value through profit or loss	135	-	135
Net gains on available-for-sale financial assets	5	-	5
Net interest	(393)	-	(393)
Other income	374	29	403
External revenues net of interest	4,203	29	4,232
Other expense	(3,853)	(55)	(3,908)
Loss on disposal of subsidiaries	(151)	-	(151)
Profit/ (loss) before income tax	199	(26)	173
Income tax (expense)/ credit	(142)	6	(136)
Profit/ (loss) for the year	57	(20)	37
Consolidated statement of financial position information:			
Segment assets	519,386	7	519,566
Segment liabilities	503,850	7	503,907
Other segment information:			
Capital expenditure	1	-	1
Depreciation and amortisation	3	-	3

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Year ended 31 December 2013

25. SEGMENT REPORTING (CONTINUED)

2012	Institutional securities \$millions	Investment management \$millions	Other \$millions	Total \$millions
Consolidated income statement information:				
Net gains/(losses) on financial instruments classified as held for trading	3,577	-	(6)	3,571
Net gains on financial instruments designated at fair value through profit or loss	96	-	-	96
Net gains on available-for-sale financial assets	50	-	-	50
Net interest	(438)	-	1	(437)
Other income	345	41	8	394
External revenues net of interest	3,630	41	3	3,674
Other expense	(3,334)	(67)	(1)	(3,402)
Loss on disposal of subsidiaries	(30)	-	-	(30)
Profit/ (loss) before income tax	266	(26)	2	242
Income tax (expense)/ credit	(239)	6	-	(233)
Profit/ (loss) for the year	27	(20)	2	9
Consolidated statement of financial position information:				
Segment assets (restated)*	548,479	4	4,358	552,841
Segment liabilities (restated)*	535,669	1	3,646	539,316
Other segment information:				
Capital expenditure	1	-	-	1
Depreciation and amortisation	3	-	-	3

*Details of the restatement are provided in note 2.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

25. SEGMENT REPORTING (CONTINUED)

Geographical segments

The Group operates in three geographic regions being EMEA, the Americas and Asia.

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

	EMEA		Americas		Asia		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
	Smillions	Smillions	Smillions	Smillions	Smillions	Smillions	Smillions	Smillions
External revenues net of interest	4,093	3,530	23	(20)	116	164	4,232	3,674
Profit / (loss) before income tax	157	332	(25)	(120)	41	30	173	242
Total assets ⁽¹⁾	415,084	454,096	51,586	55,397	52,896	43,348	519,566	552,841

(1) The 31 December 2012 EMEA total assets balance has been restated; details of the restatement are provided in note 2.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT

Risk management procedures

Risk is an inherent part of the Group's business activity. The Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities in accordance with defined policies and procedures. The Group 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 Group's Board of directors and to appropriate senior management personnel of the Group.

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

Credit risk

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations to the Group.

The credit risk management policies and procedures of the Group establish the framework for ensuring transparency of material credit risks, ensuring compliance with established limits and escalating risk concentrations to appropriate senior management.

The Group primarily incurs credit risk exposure to institutions and sophisticated investors primarily through its Institutional Securities segment. This risk may be incurred through a variety of activities, including, but not limited to, entering into swap or other derivative contracts under which counterparties have obligations to make payments to the Group; extending credit to clients through various lending commitments; providing short-term or long-term funding that is secured by physical or financial collateral whose value may at times be insufficient to cover the loan repayment amount; posting margin and/ or collateral to clearing houses, clearing agencies, exchanges, banks, securities firms and other financial counterparties; and investing or trading in securities and loan pools, whereby the value of these assets may fluctuate based on realised or expected defaults on the underlying obligations or loans.

In order to mitigate credit risk for the Group, the Credit Risk Management Department establishes firm-wide practices to identify, monitor and control credit risk exposure at the transaction, obligor and portfolio levels. A comprehensive and global Credit Limits Framework is also utilised to evaluate and manage credit risk levels across the firm. The Credit Limits Framework is calibrated within the firm's risk tolerance and includes single-name limits and portfolio concentration limits by country, industry and product type. The Credit Risk Management Department ensures transparency of material credit risks, compliance with established limits and escalation of risk concentrations to appropriate senior management.

The Credit Risk Management Department also works closely with the Market Risk Department and applicable business units to monitor risk exposures and to perform stress tests to identify, analyse and control credit risk concentrations arising in the Group's lending and trading activities. The stress tests shock market factors (e.g., interest rates, commodity prices, equity prices) and risk parameters such as default probabilities and expected losses in order to identify potential credit exposure concentrations to individual counterparties, countries and industries. Stress and scenario tests are conducted in accordance with established Group's policies and procedures and comply with methodologies outlined in the Basel regulatory framework.

The Credit Risk Management Department approves extensions of credit, evaluates the creditworthiness of the Group's obligors on a regular basis, and ensures that credit exposure is actively monitored and managed. The evaluation of obligors includes an assessment of the probability that an obligor will default on its financial obligations and any subsequent losses that may occur when an obligor defaults.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

In addition to assessing and monitoring its credit exposure and risk at the individual obligor level, the Group also reviews its credit exposure and risk to geographic regions. As at 31 December 2013, credit exposure was concentrated in Asian and Western European countries. In addition, the Group pays particular attention to smaller exposures in emerging markets given their unique risk profile. Country ceiling ratings are derived using methodologies generally consistent with those employed by external rating agencies. The Group also reviews its credit exposure and risk to types of customers. At 31 December 2013, the Group's material credit exposure was to corporate entities, sovereign-related entities and financial institutions.

Collateral and other credit enhancements

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

- *Securities purchased under agreements to resell and securities borrowed*

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

- *Derivatives*

The Group may seek to mitigate credit risk from its derivatives transactions in multiple ways, including documentation, collateral provisions, guarantees and hedges. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size, tenor, financial covenants, seniority and collateral. The Group actively hedges its derivatives exposure through various financial instruments that may include single-name, portfolio and structured credit derivatives. The Group may enter into master netting agreements and collateral arrangements with obligors. These master netting agreements and collateral arrangements may provide the Group with the ability to demand collateral, as well as to liquidate collateral and offset receivables and payables covered under the same master netting agreement in the event of counterparty default. The Group monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral in accordance with collateral arrangements when deemed necessary.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk

The maximum exposure to credit risk ("gross credit exposure") of the Group as at 31 December 2013 is disclosed below, based on the carrying amounts of the financial assets the Group believes are subject to credit risk. Exposure arising from financial instruments not recognised on the consolidated statement of financial position is measured as the maximum amount that the Group could have to pay, which may be significantly greater than the amount that would be recognised as a liability. This table does not include receivables arising from pending securities transactions with market counterparties. Where the Group enters into credit enhancements, including receiving cash and security as collateral and master netting agreements, to manage the credit exposure on these financial instruments the financial effect of the credit enhancements is also disclosed below. The net credit exposure represents the credit exposure remaining after the effect of the credit enhancements. The "unrated" balance in the 'Maximum exposure to credit risk by credit rating' represents the pool of counterparties that either do not require a rating or are under review in accordance with the Group's rating policies. These counterparties individually generate no material credit exposure and this pool is highly diversified, monitored and subject to limits.

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk (continued)

Exposure to credit risk by class:

Class	2013			2012		
	Gross credit exposure ⁽¹⁾	Credit enhancements	Net credit exposure ⁽²⁾	Gross credit exposure ⁽¹⁾	Credit enhancements	Net credit exposure ⁽²⁾
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Loans and receivables:						
Cash and short term deposits	12,244	-	12,244	11,526	-	11,526
Cash collateral on securities borrowed (restated)*	17,372	(16,810)	562	19,733	(19,631)	102
Securities purchased under agreements to resell	75,717	(73,030)	2,687	99,782	(99,344)	438
Trade receivables (3)	47,848	-	47,848	47,246	-	47,246
Other receivables	2,336	-	2,336	5,139	-	5,139
Financial assets classified as held for trading:						
Derivatives	264,793	(252,050)	12,743	266,643	(253,192)	13,451
Financial assets designated at fair value through profit or loss	7,673	(5,643)	2,030	7,591	(6,174)	1,417
	427,983	(347,533)	80,450	457,660	(378,341)	79,319
Unrecognised financial instruments						
Contingent commitments	821	-	821	2,172	-	2,172
Letters of credit	1	-	1	5	-	5
Loan commitments	1,870	-	1,870	985	-	985
Underwriting commitments	588	-	588	44	-	44
Unsettled securities purchased under agreements to resell (4)	23,857	-	23,857	25,370	-	25,370
	455,120	(347,533)	107,587	486,236	(378,341)	107,895

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

(2) Of the residual net credit exposure, intercompany cross product netting arrangements are in place which would allow for an additional \$2,977 million (2012: \$9,897 million) to be offset in the event of default by certain Morgan Stanley counterparties.

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

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

*Details of the restatement are provided in note 2.

The impact of master netting arrangements and similar agreements on the Group's ability to offset financial assets and financial liabilities is disclosed in note 29.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk (continued)

Maximum exposure to credit risk by credit rating(1):

Credit rating:	Gross credit exposure	
	2013 \$millions	2012 \$millions
AAA	12,572	19,267
AA	97,249	109,840
A (restated)*	259,253	278,825
BBB	52,084	51,106
BB	17,344	14,478
B	7,113	6,604
CCC	3,889	3,833
Unrated	5,616	2,283
	<u>455,120</u>	<u>486,236</u>

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

*Details of the restatement are provided in note 2

At 31 December 2013, there were no financial assets past due but not impaired or individually impaired (2012: \$none).

Liquidity and funding risk

Liquidity and funding risk refers to the risk that the Group will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity and funding risk also encompasses the Group's ability to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten its viability as a going concern.

The Group's liquidity and funding risk management policies and procedures are consistent with those of the Morgan Stanley Group. The Board of directors of the Group, is ultimately responsible for establishing the liquidity risk tolerance and ensuring the Group's liquidity risk is appropriately managed. In addition to the internal liquidity risk management framework, the Group is locally subject to the liquidity regulations prescribed by the PRA. The Group has daily monitoring and reporting processes in place to ensure compliance with its regulatory requirements.

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

The following principles guide the Group's liquidity and funding 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
- Limited access to funding should be anticipated through the Contingency Funding Plan ("CFP").

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

The core components of the Group's liquidity and funding risk management framework are the Contingency Funding Plan ("CFP"), Liquidity Stress Tests and the Liquidity Reserve (as defined below), which support the Group's target liquidity profile.

Contingency Funding Plan

A CFP is prepared for the UK Defined Liquidity Group ("DLG") which consists of the Company, and two other UK Morgan Stanley Group undertakings. The Company is the largest component of the DLG. CFP describes the data and information flows, limits, targets, operating environment indicators, escalation procedures, roles and responsibilities, and available mitigating actions in the event of a liquidity stress. The CFP also sets forth the principal elements of the DLG's liquidity stress testing which identifies stress events of different severity and duration, assesses current funding sources and uses and establishes a plan for monitoring and managing a potential liquidity stress event.

Liquidity Stress Tests

The Group, as part of the DLG, uses liquidity stress tests to model liquidity outflows across multiple scenarios over a range of time horizons. These scenarios contain various combinations of idiosyncratic and systemic stress events.

The assumptions underpinning the Liquidity Stress Tests include, but are not limited to, the following:

- No government support;
- No access to equity and unsecured debt markets;
- Repayment of all unsecured debt maturing within the stress horizon;
- Higher haircuts and significantly lower availability of secured funding;
- Additional collateral that would be required by trading counterparties, certain exchanges and clearing organisations related to credit rating downgrades;
- Additional collateral that would be required due to collateral substitutions, collateral disputes and uncalled collateral;
- Discretionary unsecured debt buybacks;
- Drawdowns on unfunded commitments provided to third parties;
- Client cash withdrawals and reduction in customer short positions that fund long positions;
- Limited access to the foreign exchange swap markets;
- Return of securities borrowed on an uncollateralised basis; and
- Maturity roll-off of outstanding letters of credit with no further issuance.

Liquidity Stress Tests are produced for the DLG, as well as at major currency levels, to capture specific cash requirements and cash availability across the DLG. The Stress Tests assume that a legal entity will use their own liquidity first to fund their obligations before drawing liquidity from its ultimate parent undertaking, Morgan Stanley. Morgan Stanley will support its subsidiaries and will not have access to subsidiaries' liquidity reserves that are subject to any regulatory, legal or tax constraints.

At December 31, 2013, the Group, through the DLG, maintained sufficient liquidity to meet current and contingent funding obligations as modeled in its Liquidity Stress Tests.

Liquidity Reserve

The Group maintains sufficient liquidity reserves ("Liquidity Reserve") to cover daily funding needs and to meet strategic liquidity targets sized by the CFP and Liquidity Stress Tests. The size of the Liquidity

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Liquidity Reserve (continued)

Reserve is actively managed by the Group. The following components are considered in sizing the Liquidity Reserve: unsecured debt maturity profile, balance sheet size and composition, funding needs in a stressed environment inclusive of contingent cash outflows and collateral requirements. Additionally, the Liquidity Reserve includes an additional reserve, which is primarily a discretionary surplus based on the Group's risk tolerance and is subject to change dependent on market and entity-specific events.

The Group holds its own Liquidity Reserve which is composed of diversified cash and cash equivalents and highly liquid unencumbered securities. Eligible unencumbered securities include primarily non-US government securities in addition to US government securities and other highly liquid investment grade securities.

Basel Liquidity Framework

The Basel Committee has developed two standards intended for use in liquidity risk supervision: the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"). The Group will be subject to both ratios under the local adoption of Basel III regulations, which will be implemented in phases over several years.

Funding Management

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

The Group funds itself through diverse sources. These sources may include the Group's equity capital, long-term debt, repurchase agreements and securities lending. The Group has an active financing program for structured products targeting global investors and currencies.

Secured Financing. A substantial portion of the Group's total assets consists of liquid marketable securities. The liquid nature of these assets provides the Group with flexibility in funding these assets with secured financing. The Group's goal is to achieve an optimal mix of durable secured and unsecured financing. Secured financing investors principally focus on the quality of the eligible collateral posted. Accordingly, the Group actively manages its secured financing book based on the quality of the assets being funded.

The Group utilises shorter-term secured financing only for highly liquid assets and has established longer tenor limits for less liquid asset classes, for which funding may be at risk in the event of a market disruption. The Group defines highly liquid assets as those that are consistent with the standards of the Liquidity Reserve, and less liquid assets as those that do not meet these standards. To further minimise the refinancing risk of secured financing for less liquid assets, the Group has established concentration limits to diversify its investor base and reduce the amount of monthly maturities for secured financing of less liquid assets. Furthermore, the Group obtains spare capacity, or term secured funding liabilities in excess of less liquid inventory, as an additional risk mitigant to replace maturing trades in the event that secured financing markets or our ability to access them become limited. Finally, in addition to the above risk management framework, the Group holds a portion of its Liquidity Reserve against the potential disruption to its secured financing capabilities.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Funding Management (continued)

Unsecured Financing. The Group views long-term debt as a stable source of funding. The Group's unsecured financings include structured borrowings, whose payments and redemption values are based on the performance of certain underlying assets, including equity, credit, foreign exchange, interest rates and commodities. When appropriate, the Group may use derivative products to conduct asset and liability management and to make adjustments to the Group's interest rate and structured borrowings risk profile.

Maturity analysis

In the following maturity analysis of financial liabilities, derivative contracts and other financial liabilities held as part of the Group's trading activities are presented at fair value, consistent with how these financial liabilities are managed, and disclosed as on demand. Derivatives not held as part of the Group's trading activities 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 liabilities are managed. All other amounts represent undiscounted cash flows payable by the Group arising from its financial liabilities to earliest contractual maturities as at 31 December 2013. Repayments of financial liabilities that are subject to immediate notice are treated as if notice were given immediately and are classified as on demand. This presentation is considered by the Group to appropriately reflect the liquidity risk arising from those financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial liabilities is managed by the Group.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Maturity analysis (continued)

31 December 2013	On demand Smillions	Less than 1 month Smillions	Equal to or more than 1 month but less than 3 months Smillions	Equal to or more than 3 months but less than 1 year Smillions	Equal to or more than 1 year but less than 5 years Smillions	Equal to or more than 5 years Smillions	Total Smillions
Financial liabilities							
Financial liabilities at amortised cost							
Bank loans and overdrafts	16	-	-	-	-	-	16
Cash collateral on securities loaned	11,555	150	483	1,269	-	-	13,457
Securities sold under agreements to repurchase	22,483	23,781	10,689	10,955	2,178	-	70,086
Trade payables	97,946	-	-	-	-	-	97,946
Subordinated loans	-	-	-	140	1,090	10,958	12,188
Other payables	5,364	3	6	8,241	1,369	4,120	19,103
Financial liabilities classified as held for trading							
Derivatives	253,435	-	-	-	-	-	253,435
Other	29,329	-	-	-	-	-	29,329
Financial liabilities designated at fair value through profit or loss							
	9,463	45	252	335	2,714	314	13,123
Total financial liabilities	429,591	23,979	11,430	20,940	7,351	15,392	508,683
Unrecognised financial instruments							
Contingent commitments	821	-	-	-	-	-	821
Lease commitments	-	1	2	5	21	9	38
Letters of credit	1	-	-	-	-	-	1
Loan commitments	1,870	-	-	-	-	-	1,870
Underwriting commitments	-	-	275	313	-	-	588
Unsettled securities purchased under agreements to resell ⁽¹⁾	15,846	8,011	-	-	-	-	23,857
Total unrecognised financial instruments	18,538	8,012	277	318	21	9	27,175

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 31 December 2013 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 31 December 2013, \$15,846 million settled within three business days.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Maturity analysis (continued)

31 December 2012	On demand Smillions	Less than 1 month Smillions	Equal to or more than 1 month but less than 3 months Smillions	Equal to or more than 3 months but less than 1 year Smillions	Equal to or more than 1 year but less than 5 years Smillions	Equal to or more than 5 years Smillions	Total Smillions
Financial liabilities							
Financial liabilities at amortised cost							
Bank loans and overdrafts	23	-	-	-	-	-	23
Cash collateral on securities loaned (restated)*	12,956	1,396	973	2,137	304	-	17,766
Securities sold under agreements to repurchase	29,916	27,874	11,600	12,283	3,697	324	85,694
Trade payables	83,161	-	-	-	-	-	83,161
Subordinated loans	-	-	-	144	847	10,516	11,507
Other payables	8,170	1	3	6,234	63	4,160	18,631
Financial liabilities classified as held for trading							
Derivatives	278,270	-	-	-	-	-	278,270
Other	35,778	-	-	-	-	-	35,778
Financial liabilities designated at fair value through profit or loss							
	8,004	69	81	571	3,227	608	12,560
Total financial liabilities	456,278	29,340	12,657	21,369	8,138	15,608	543,390
Unrecognised financial instruments							
Contingent commitments	2,172	-	-	-	-	-	2,172
Lease commitments	-	1	2	5	23	13	44
Letters of credit	5	-	-	-	-	-	5
Loan commitments	985	-	-	-	-	-	985
Underwriting commitments	44	-	-	-	-	-	44
Unsettled securities purchased under agreements to resell ⁽¹⁾	20,648	4,722	-	-	-	-	25,370
Total unrecognised financial instruments	23,854	4,723	2	5	23	13	28,620

*Details of the restatement are provided in note 2

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 31 December 2012 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 31 December 2012, \$20,648 million settled within three business days.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk

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

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

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

Primary market risk exposures and market risk management

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

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

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

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

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Primary market risk exposures and market risk management (continued)

The Group manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (e.g., futures, forwards, swaps and options). Hedging activities may not always provide effective mitigation against trading losses due to differences in the terms, specific characteristics or other basis risks that may exist between the hedge instrument and the risk exposure that is being hedged. The Group manages and monitors its market risk exposures in such a way as to maintain a portfolio that the Group believes is well-diversified in the aggregate with respect to market risk factors and that reflects the Group's aggregate risk tolerance, as established by the Group's Board of directors.

Aggregate market risk limits have been approved for the Group as well as for material operating entities. Additional market risk limits are assigned to trading desks. Trading division risk managers, desk risk managers, traders and the market risk department monitor market risk measures against limits in accordance with policies set by the Board of directors.

VaR

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

VaR methodology, assumptions and limitations

The Group estimates VaR using a model based on volatility adjusted historical simulation for general market risk factors and Monte Carlo simulation for name-specific risk in corporate shares, bonds, loans and related derivatives. The model constructs a distribution of hypothetical daily changes in the value of trading portfolios based on the following: historical observation of daily changes in key market indices or other market risk factors; and information on the sensitivity of the portfolio values to these market risk factor changes. The Group's VaR model uses four years of historical data with a volatility adjustment to reflect current market conditions. The Group's Management VaR is computed at a 95% level of confidence over a one day time horizon, which is a useful indicator of possible trading losses resulting from adverse daily market moves. The Group's 95%/one-day VaR corresponds to the unrealised loss in portfolio value that, based on historically observed market risk factor movements, would have been exceeded with a frequency of 5%, or five times in every 100 trading days, if the portfolio were held constant for one day.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR methodology, assumptions and limitations (continued)

Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of varied market risks and portfolio assets. One key element of the VaR model is that it reflects risk reduction due to portfolio diversification or hedging activities. However, VaR has various limitations, which include but are not limited to: use of historical changes in market risk factors, which may not be accurate predictors of future market conditions, and may not fully incorporate the risk of extreme market events that are outsized relative to observed historical market behaviour or reflect the historical distribution of results beyond the 95% confidence interval; and reporting of losses in a single day, which does not reflect the risk of positions that cannot be liquidated or hedged in one day. A small proportion of market risk generated by trading positions is not included in VaR. The modeling of the risk characteristics of some positions relies on approximations that, under certain circumstances, could produce significantly different results from those produced using more precise measures. VaR is most appropriate as a risk measure for trading positions in liquid financial markets and will understate the risk associated with severe events, such as periods of extreme illiquidity. The Group is aware of these and other limitations and, therefore, uses VaR as only one component in its risk management oversight process. This process also incorporates stress testing and scenario analyses and extensive risk monitoring, analysis, and control at the trading desk, division, entity and global levels.

The Group's VaR model evolves over time in response to changes in the composition of trading portfolios and to improvements in modelling techniques and systems capabilities. The Group is committed to continuous review and enhancement of VaR methodologies and assumptions in order to capture evolving risks associated with changes in market structure and dynamics. As part of regular process improvement, additional systematic and name-specific risk factors may be added to improve the VaR model's ability to more accurately estimate risks to specific asset classes or industry sectors.

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

Sensitivity analysis

VaR for the year ended 31 December 2013

The table below presents the Management VaR for the Group's Trading portfolio on a year-end, annual average and annual high and low basis for 31 December 2013 and nine months to 31 December 2012 as a comparative.

The Credit Portfolio VaR is disclosed as a separate category from the Primary Risk Categories and includes loans that are carried at fair value and associated hedges as well as counterparty credit valuation adjustments and related hedges.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Sensitivity analysis (continued)

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

	95%/ one-day VaR for the year ended 31 December 2013				95%/ one-day VaR for the nine months ended ⁽¹⁾ 31 December 2012			
	Period end Smillions	Average Smillions	High Smillions	Low Smillions	Period end Smillions	Average Smillions	High Smillions	Low Smillions
<i>Market risk category:</i>								
Interest rate and credit spread	15	13	24	9	17	18	28	14
Equity price	14	14	32	11	13	16	29	12
Foreign exchange rate	5	4	8	2	3	3	8	2
Commodity price	1	1	2	1	1	2	4	1
Less diversification benefit (1)(2)	(15)	(12)	N/A	N/A	(13)	(15)	N/A	N/A
Primary Risk Categories	20	20	37	15	21	24	42	19
Credit Portfolio	6	8	12	6	13	14	17	12
Less diversification benefit (1)(2)	(4)	(6)	N/A	N/A	(7)	(8)	N/A	N/A
Total Management VaR	22	22	41	17	27	30	51	22

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

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

(3) A new VaR model was effective from 1 April 2012 therefore comparative VaR is shown for the nine months ended 31 December 2012.

The Group's average Management VaR for Primary Risk Categories for 2013 was \$20 million compared with \$24 million for 2012. The decrease in average VaR for Primary Risk Categories is primarily due to reduced exposure to interest rates and credit spreads.

The average Credit Portfolio VaR for 2013 was \$8 million compared with \$14 million for 2012. The decrease in the average VaR over the year was from decreased counterparty exposure during 2013.

The average total Management VaR for 2013 was \$22 million compared with \$30 million for 2012.

Non-trading risks for the year ended 31 December 2013

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net loss or gain of approximately \$3.8 million, compared to a net gain or loss of \$2.5 million as at 31 December 2012.

Counterparty exposure related to own spreads

The credit spread risk relating to the Group's own mark-to-market derivative counterparty exposure is managed separately from VaR. The credit spread risk sensitivity of this exposure corresponds to an increase in value of approximately \$2.7 million and \$3 million for each 1 basis point widening in the Group's credit spread level for both 31 December 2013 and 31 December 2012, respectively.

Funding liabilities

The credit spread risk sensitivity of the Group's mark-to-market funding liabilities corresponds to an increase in value of approximately \$0.5 million and \$0.7 million for each 1 basis point widening in the Group's credit spread level for both 31 December 2013 and 31 December 2012, respectively.

Equity investments price risk

The Group is exposed to equity price risk as a result of changes in the fair value of its investments in both exchange traded equity securities and private equities classified as available-for-sale financial assets. These investments are predominantly equity positions with long investment horizons, the majority of which are for business facilitation purposes. The market risk related to these investments is measured by estimating the potential reduction in net revenues associated with a 10% decline in asset values as shown in the table below.

	31 December 2013 10% sensitivity \$millions	31 December 2012 10% sensitivity \$millions
Available-for-sale financial assets	6	4

Currency risk

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

The analysis below details the foreign currency exposure for the Group, by foreign currency, relating to the retranslation of its non-US dollar denominated branches and subsidiaries. The analysis calculates the impact on total comprehensive income of a reasonably possible parallel shift of the foreign currency in relation to the US dollar, with all other variables held constant. This analysis does not take into account the effect of the foreign currency hedges held by other members of the Morgan Stanley Group.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

26. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk (continued)

	2013			2012		
	Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)		
	Foreign currency exposure	Percentage change applied	Other comprehensive income	Foreign currency exposure	Percentage change applied	Other comprehensive income
	\$millions	%	\$millions	\$millions	%	\$millions
Australian Dollar	(40)	27%	(11)	(16)	27%	(4)
British Pound	57	11%	6	55	29%	16
Euro	479	7%	34	450	7%	31
New Taiwan Dollar	65	8%	5	62	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Polish Zloty	4	16%	1	2	16%	-
South Korean Won	203	12%	24	206	42%	87
Swedish Krona	17	9%	2	16	23%	4
Swiss Franc	11	10%	1	10	10%	1
	798		62	787		140

The reasonably possible percentage change in the currency rate in relation to the US dollar has been calculated based on the greatest annual percentage change over the 5 year period from 1 January 2009 to 31 December 2013 (2012: from 1 December 2007 to 31 December 2012). Thus, the percentage change applied may not be the same percentage as the actual change in the currency rate for the year.

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

27. TRANSFERS OF FINANCIAL ASSETS, INCLUDING PLEDGES OF COLLATERAL

Transferred financial assets that are not derecognised in their entirety

In the ordinary course of business, the Group enters into various arrangements including selling securities under agreements to repurchase, purchasing securities under agreements to resell, securities borrowed and securities loaned to, amongst other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Group's inventory positions.

The Group pledges certain financial instruments to collateralise repurchase agreements and other securities financings. Pledged financial instruments that can be sold or replugged by the secured party are identified as financial instruments classified as held for trading (pledged to various parties) in the consolidated statement of financial position. The Group has determined that it retains substantially all the risks and rewards of these financial instruments including credit risk, settlement risk, country risk and market risk, and therefore has not derecognised them. In addition, it recognises a financial liability in respect of the consideration received.

Other financial assets transferred that continue to be recognised for accounting purposes include pledges of securities as collateral for derivative transactions or otherwise, as well as certain sales of securities with related transactions, such as derivatives, that result in the Group retaining substantially all the risks and rewards of the financial assets transferred. In addition, it recognises a financial liability in respect of the consideration received.

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

The following table presents those financial assets which have been sold or otherwise transferred, but which for accounting purposes remain recognised on the consolidated statement of financial position.

	2013	2012
	\$millions	\$millions
Financial assets classified as held for trading		
Government debt securities	15,599	20,095
Corporate and other debt	5,681	11,432
Corporate equities	38,006	22,732
	<u>59,286</u>	<u>54,259</u>

28. FINANCIAL ASSETS ACCEPTED AS COLLATERAL

The Group's policy is generally to take possession of securities received as collateral, securities purchased under agreements to resell and securities borrowed. The Group monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralised. Where deemed appropriate, the Group's agreements with third parties specify its rights to request additional collateral. These transactions are mostly conducted under standard documentation used by financial market participants.

The fair value of collateral accepted under these arrangements as at 31 December 2013 was \$171,914 million (2012: \$207,063 million). Of this amount \$130,137 million (2012: \$170,564 million) has been sold or replugged to third parties in connection with financing activities, or to comply with commitments under short sale transactions.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS **Year ended 31 December 2013**

29. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING

In order to manage credit exposure arising from its business activities, the Group applies various credit risk management policies and procedures, see note 26 for further details. Primarily in connection with securities purchased under agreements to resell and securities sold under agreements to repurchase, securities borrowed and securities loaned transactions and derivative transactions, the Group enters into master netting arrangements and collateral arrangements with its counterparties. These agreements provide the Group with the right, in the ordinary course of business and/ or in the event of a counterparty default (such as bankruptcy or a counterparty's failure to pay or perform), to net a counterparty's rights and obligations under such agreement and, in the event of counterparty default, set off collateral held by the Group against the net amount owed by the counterparty. However, in certain circumstances, the Group may not have such an agreement in place; the relevant insolvency regime (which is based on type of counterparty entity and the jurisdiction of organisation of the counterparty) may not support the enforceability of the agreement; or the Group may not have sought legal advice to support the enforceability of the agreement. In cases where the Group has not determined an agreement to be enforceable, the related amounts are not offset in the tabular disclosures. The Group's policy is generally to take possession of securities purchased under agreements to resell and securities borrowed, and to receive securities and cash posted as collateral (with rights of rehypothecation), although in certain cases the Group may agree for such collateral to be posted to a third party custodian under a tri-party arrangement that enables the Group to take control of such collateral in the event of a counterparty default. The enforceability of the master netting agreement is taken into account in the Group's risk management practices and application of counterparty credit limits. The Group also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral as provided under the applicable agreement to ensure such transactions are adequately collateralised.

In the consolidated statement of financial position, financial assets and financial liabilities are only offset and presented on a net basis where there is a current legally enforceable right to set off the recognised amounts and an intention to either settle on a net basis or to realise the asset and the liability simultaneously. In the absence of such conditions, financial assets and financial liabilities are presented on a gross basis.

The following tables present information about the offsetting of financial instruments and related collateral amounts. It does not include information about financial instruments that are subject only to a collateral agreement. The effect of master netting arrangements, collateral agreements and other credit enhancements, on the Group's exposure to credit risk is disclosed in note 26.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

29. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING (CONTINUED)

	Gross amounts ⁽¹⁾ Smillions	Amounts offset in the consolidated statement of financial position ⁽²⁾ Smillions	Net amounts presented in the consolidated statement of financial position Smillions	Amounts not offset in the consolidated statement of financial position ^{(3) (4) (5) (6)} Financial instruments Smillions	Cash collateral Smillions	Net exposure ⁽⁷⁾ Smillions
31 December 2013						
Assets						
Loans and receivables:						
Cash collateral on securities borrowed	33,116	(15,744)	17,372	(16,810)	-	562
Securities purchased under agreement to resell	106,971	(31,254)	75,717	(73,030)	-	2,687
Financial assets classified as held for trading:						
Derivatives	285,746	(20,953)	264,793	(221,798)	(30,261)	12,734
TOTAL	425,833	(67,951)	357,882	(311,638)	(30,261)	15,983
Liabilities						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned	29,201	(15,744)	13,457	(13,185)	-	272
Securities sold under agreement to repurchase	101,270	(31,254)	70,016	(63,488)	-	6,528
Financial liabilities classified as held for trading:						
Derivatives	274,388	(20,953)	253,435	(218,997)	(18,243)	16,195
TOTAL	404,859	(67,951)	336,908	(295,670)	(18,243)	22,995

(1) Amounts include \$338 million of cash collateral on securities borrowed, \$2,202 million of securities purchased under agreements to resell, \$6,372 million of financial assets classified as held for trading - derivatives, \$7 million of cash collateral on securities loaned, \$6,512 million of securities sold under agreements to repurchase and \$6,151 million of financial liabilities classified as held for trading - derivatives which are either not subject to master netting agreements or collateral agreements or are subject to such agreements but the Group has not determined the agreements to be legally enforceable.

(2) Amounts are reported on a net basis in the consolidated statements of financial position when there is a legally enforceable master netting arrangement that provides for a current right of offset and there is an intention to either settle on a net basis or to realise the asset and liability simultaneously.

(3) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Group to be legally enforceable but do not meet all criteria required for net presentation within the consolidated statement of financial position.

(4) The cash collateral is recognised in the consolidated statement of financial position within trade receivables and payables respectively.

(5) Certain other trade receivables and payables that are not presented net within the consolidated statement of financial position have legally enforceable master netting agreements or similar arrangements in place which would allow for an additional \$8,595 million to be offset in the event of default.

(6) Certain financial assets and financial liabilities designated at fair value through profit or loss have legally enforceable master netting arrangements in place; however, these are not eligible for netting within the consolidated statement of financial position. \$15 million not presented net in the consolidated statement of financial position have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/ or in the event of default.

(7) Of the residual net exposure, intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$2,977 million to be offset in the ordinary course of business and / or in the event of default.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

29. FINANCIAL ASSETS AND FINANCIAL LIABILITIES SUBJECT TO OFFSETTING (CONTINUED)

	Gross amounts ⁽¹⁾ Smillions	Amounts offset in the consolidated statement of financial position ⁽²⁾ Smillions	Net amounts presented in the consolidated statement of financial position Smillions	Amounts not offset in the consolidated statement of financial position ^{(3) (4) (5) (6)} Financial instruments Smillions	Cash collateral Smillions	Net exposure ⁽⁷⁾ Smillions
31 December 2012						
Assets						
Loans and receivables:						
Cash collateral on securities borrowed (restated)*	31,303	(11,570)	19,733	(19,117)	-	616
Securities purchased under agreement to resell	120,487	(20,705)	99,782	(95,398)	-	4,384
Financial assets classified as held for trading:						
Derivatives	283,782	(1,122)	282,660	(240,556)	(29,464)	12,640
TOTAL	435,572	(33,397)	402,175	(355,071)	(29,464)	17,640
Liabilities						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned (restated)*	29,336	(11,570)	17,766	(17,415)	-	351
Securities sold under agreement to repurchase	106,399	(20,705)	85,694	(81,642)	-	4,052
Financial liabilities classified as held for trading:						
Derivatives	279,392	(1,122)	278,270	(243,597)	(22,330)	12,343
TOTAL	415,127	(33,397)	381,730	(342,654)	(22,330)	16,746

*Details of the restatement are provided in note 2.

- (1) Amounts include \$196 million of cash collateral on securities borrowed, \$4,125 million of securities purchased under agreements to resell, \$1,473 million of financial assets classified as held for trading - derivatives, \$9 million of cash collateral on securities loaned, \$3,760 million of securities sold under agreements to repurchase and \$1,373 million of financial liabilities classified as held for trading - derivatives which are either not subject to master netting agreements or collateral agreements or are subject to such agreements but the Group has not determined the agreements to be legally enforceable.
- (2) Amounts are reported on a net basis in the consolidated statements of financial position when there is a legally enforceable master netting arrangement that provides for a current right of offset and there is an intention to either settle on a net basis or to realise the asset and liability simultaneously.
- (3) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Group to be legally enforceable but do not meet all criteria required for net presentation within the consolidated statement of financial position.
- (4) The cash collateral is recognised in the consolidated statement of financial position within trade receivables and payables respectively.
- (5) Certain other trade receivables and payables that are not presented net within the consolidated statement of financial position have legally enforceable master netting agreements or similar arrangements in place which would allow for an additional \$4,559 million to be offset in the event of default.
- (6) Certain financial assets and financial liabilities designated at fair value through profit or loss have legally enforceable master netting arrangements in place; however, these are not eligible for netting within the consolidated statement of financial position. \$226 million not presented net in the consolidated statement of financial position have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/ or in the event of default.
- (7) Of the residual net exposure, intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$2,749 million to be offset in the ordinary course of business and / or in the event of default.

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Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS 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 Group's financial assets and financial liabilities recognised at fair value on a recurring basis, classified according to the fair value hierarchy.

2013

	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant unobservable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
Government debt securities	7,861	1,819	23	9,703
Corporate and other debt	3	11,030	714	11,747
Corporate equities	42,032	2,579	69	44,680
Derivatives	1,256	259,656	3,881	264,793
Total financial assets classified as held for trading	51,152	275,084	4,687	330,923
Financial assets designated at fair value through profit or loss	-	6,075	1,598	7,673
Available-for-sale financial assets:				
Corporate equities	2	-	58	60
Total financial assets measured at fair value	51,154	281,159	6,343	338,656
Financial liabilities classified as held for trading:				
Government debt securities	6,546	2,259	-	8,805
Corporate and other debt	4	2,640	47	2,691
Corporate equities	17,310	515	8	17,833
Derivatives	851	248,173	4,411	253,435
Total financial liabilities classified as held for trading	24,711	253,587	4,466	282,764
Financial liabilities designated at fair value through profit or loss	-	12,866	257	13,123
Total financial liabilities measured at fair value	24,711	266,453	4,723	295,887

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

2012

	Quoted prices in active market (Level 1) Smillions	Valuation techniques using observable inputs (Level 2) Smillions	Valuation techniques with significant unobservable inputs (Level 3) Smillions	Total Smillions
Financial assets classified as held for trading:				
Government debt securities	14,783	3,368	2	18,153
Corporate and other debt	1	9,412	963	10,376
Corporate equities	29,624	768	113	30,505
Derivatives	470	279,179	3,011	282,660
Total financial assets classified as held for trading	44,878	292,727	4,089	341,694
Financial assets designated at fair value through profit or loss	-	7,014	577	7,591
Available-for-sale financial assets:				
Corporate equities	2	-	38	40
Total financial assets measured at fair value	44,880	299,741	4,704	349,325
Financial liabilities classified as held for trading:				
Government debt securities	14,638	2,371	-	17,009
Corporate and other debt	4	2,057	35	2,096
Corporate equities	16,240	430	3	16,673
Derivatives	426	273,601	4,243	278,270
Total financial liabilities classified as held for trading	31,308	278,459	4,281	314,048
Financial liabilities designated at fair value through profit or loss	-	12,252	308	12,560
Total financial liabilities measured at fair value	31,308	290,711	4,589	326,608

The Group'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:

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

- *Government debt securities*

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

- *Government debt securities(continued)*

US Agency Securities. US Agency Securities are composed of three main categories consisting of agency issued debt, agency mortgage pass-through pool securities and collateralised mortgage obligations. Non-callable agency issued debt securities are generally valued using quoted market prices. Callable agency issued debt securities are valued by benchmarking model-derived prices to quoted market prices and trade data for identical or comparable securities. The fair value of agency mortgage pass-through pool securities is model driven based on spreads of the comparable To-be-announced ("TBA") security. Collateralised mortgage obligations are valued using quoted market prices and trade data adjusted by subsequent changes in related indices for identical or comparable securities. Actively traded non-callable agency issued debt securities are categorised in Level 1 of the fair value hierarchy. Callable agency issued debt securities, agency mortgage pass-through pool securities and collateralised mortgage obligations are generally categorised in Level 2 of the fair value hierarchy.

Non-US Sovereign Government Obligations. Non-US Sovereign Government obligations are valued using quoted prices in active markets when available. These bonds are generally categorised in Level 1 of the fair value hierarchy. If the market is less active or prices are dispersed, these bonds are categorised in Level 2 of the fair value hierarchy. In instances where the inputs are unobservable, these bonds are categorised in Level 3 of the fair value hierarchy.

- *Corporate and other debt*

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

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

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

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Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

• Corporate and other debt (continued)

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

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

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

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Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

• Corporate and other debt (continued)

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

• Corporate Equities

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

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

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

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

Equity investments in other Morgan Stanley Group undertakings. Where the Group has equity investments in other Morgan Stanley Group undertakings that are neither subsidiaries nor associates, the Group's share of the net asset value of the undertaking is considered the best representation of fair value for the investment. These investments are included in Level 3 of the fair value hierarchy because net asset value amounts are not considered observable.

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Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

- *Derivatives*

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

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

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

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

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

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

• Derivatives (continued)

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

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

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

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

• Customer Loans

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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 material transfers between Level 1 and Level 2 of the fair value hierarchy during the year.

During 2012, the Group reclassified approximately \$2,700 million of derivative assets and approximately \$1,981 million of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange. Also during 2012, the Group reclassified approximately \$302 million of listed derivative assets from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

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

The following tables present the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the year ended 31 December 2013. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realised and unrealised gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realised and unrealised gains (losses) on hedging instruments that have been classified by the Group within the Level 1 and/or Level 2 categories.

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

The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. Where the trading positions included in the below table are risk managed using financial instruments held by other Morgan Stanley Group undertakings, these policies potentially result in the recognition of offsetting gains or losses in the Group.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

2013	Balance at 1 January 2013	Total gains/ (losses) recognised in consolidated income statement	Total gains/ (losses) recognised in consolidated statement of comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and/or (out) of Level 3 (1)	Balance at 31 December 2013	Unrealised gains/ (losses) for Level 3 assets/ liabilities outstanding as at 31 December 2013 (2)
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Financial assets classified as held for trading										
Government debt securities	2	(4)	-	28	(5)	-	-	2	23	(4)
Corporate and other debt	963	126	-	269	(363)	-	(254)	(27)	714	38
Corporate equities	113	(20)	-	8	(51)	-	-	19	69	(23)
Total financial assets classified as held for trading	1,078	102	-	305	(419)	-	(254)	(6)	806	11
Financial assets designated at fair value through profit or loss	577	62	-	1,349	-	-	(390)	-	1,598	-
Available-for-sale financial assets										
Corporate equities	38	5	-	27	(12)	-	-	-	58	-
Total financial assets measured at fair value	1,693	169	-	1,681	(431)	-	(644)	(6)	2,462	11
Financial liabilities classified as held for trading										
Corporate and other debt	35	1	-	(4)	48	-	-	(31)	47	2
Corporate equities	3	2	-	(2)	6	-	-	3	8	1
Net derivative contracts (3)	1,232	291	-	(1,302)	-	1,624	(681)	(52)	530	103
Total financial liabilities classified as held for trading	1,270	294	-	(1,308)	54	1,624	(681)	(80)	585	106
Financial liabilities designated at fair value through profit or loss	308	(4)	-	(70)	12	69	(66)	-	257	(4)
Total financial liabilities measured at fair value	1,578	290	-	(1,378)	66	1,693	(747)	(80)	842	102

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

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2013 related to assets and liabilities still outstanding at 31 December 2013. The unrealised gains or (losses) are recognised in the consolidated income statement or consolidated statement of comprehensive income as detailed in the financial instruments accounting policy (note 3c).

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

2012	Balance at 1 January 2012 Smillions	Total gains/ (losses) recognised in consolidated income statement Smillions	Total gains/ (losses) recognised in consolidated statement of comprehensive income Smillions	Purchases Smillions	Sales Smillions	Issuances Smillions	Settlements Smillions	Net transfers in and/or (out) of Level 3 (1) Smillions	Balance at 31 December 2012 Smillions	Unrealised gains/ (losses) for Level 3 assets/ liabilities outstanding as at 31 December 2012 (2) Smillions
Financial assets classified as held for trading:										
Government debt securities	1	-	-	-	-	-	-	1	2	-
Corporate and other debt	2,235	(41)	-	352	(394)	-	(1,043)	(146)	963	(33)
Corporate equities	162	3	-	45	(32)	-	-	(65)	113	6
Total financial assets classified as held for trading	2,398	(38)	-	397	(426)	-	(1,043)	(210)	1,078	(27)
Financial assets designated at fair value through profit or loss	-	-	-	266	-	-	-	311	577	-
Available-for-sale financial assets:										
Corporate equities	65	46	(16)	2	-	-	(59)	-	38	-
Total financial assets measured at fair value	2,463	8	(16)	665	(426)	-	(1,102)	101	1,693	(27)
Financial liabilities classified as held for trading:										
Corporate and other debt	70	-	-	(44)	29	-	-	(20)	35	13
Corporate equities	1	2	-	(1)	2	-	-	3	3	(1)
Net derivative contracts (3)	1,632	(342)	-	(375)	5	135	41	(548)	1,232	(175)
Total financial liabilities classified as held for trading	1,703	(340)	-	(420)	36	135	41	(565)	1,270	(163)
Financial liabilities designated at fair value through profit or loss	381	55	-	-	-	-	(18)	-	308	55
Total financial liabilities measured at fair value	2,084	(285)	-	(420)	36	135	23	(565)	1,578	(108)

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

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2012 related to assets and liabilities still outstanding at 31 December 2012. The unrealised gains or (losses) are recognised in the consolidated income statement or consolidated statement of comprehensive income as detailed in the financial instruments accounting policy (note 3c).

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

During the year, there were no material transfers from Level 3 to Level 2 of the fair value hierarchy (2012: \$1,604 million of derivative assets and \$2,152 million of derivative liabilities).

There were no material transfers from Level 2 to Level 3 of the fair value hierarchy during the year (2012: \$nil).

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis

The disclosures below provide information on the sensitivity of fair value measurements to key inputs and assumptions.

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs

The table below provides information on the valuation techniques, significant unobservable inputs and their ranges and averages for each major category of assets and liabilities measured at fair value on a recurring basis with a significant Level 3 balance.

The level of aggregation and breadth of products cause the range of inputs to be wide and not evenly distributed across the inventory. Further, the range of unobservable inputs may differ across firms in the financial services industry because of diversity in the types of products included in each firm's inventory. The following disclosures also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

31 December 2013

	Fair value Smillions	Valuation technique	Significant unobservable input(s) / sensitivity of the fair value to changes in the unobservable inputs	Range ⁽²⁾	Averages ⁽³⁾
ASSETS					
Financial assets classified as held for trading:					
- Corporate equities	69	Net Asset Value	Discount to net asset value / (C)	0% to 34%	0%
		Net Asset Value	Discount to net asset value / (C)	40% to 50%	50%
		Comparable pricing	Comparable equity price / (C)	0% to 100%	50%
		Market Approach	EBITDA Multiple / (C)	5 to 9.3 times	7.7 times
- Corporate and other debt:					
- Commercial mortgage backed securities	28	Comparable pricing	Comparable bond price / (A)	1 to 20 points	10 points
- Asset backed securities	39	Correlation model	Credit Correlation / (B)	29% to 55%	47%
		Comparable pricing	Comparable bond price / (A)	56 points	56 points
- Corporate bonds	201	Comparable pricing	Comparable bond price / (A)	5 to 133 points	106 points
		Option Model	At the money volatility / (A)	11% to 56%	25%
		Option Model	Volatility skew / (A)	-3% to 0%	-1%
		Comparable pricing	Comparable bond price / (A)	55 to 56 points	56 points
- Collateralised debt obligations	119	Comparable pricing	Comparable loan price / (A)	76 to 95 points	89 points
		Correlation Model	Credit Correlation / (B)	39% to 45%	40%
- Loans and lending commitments	110	Comparable pricing	Comparable loan price / (A)	0 to 100 points	95 points
- Other debt	193	Comparable pricing	Comparable bond price / (A)	99 to 101 points	101 points
Financial assets designated at fair value through profit or loss:					
- Customer loans	1,596	Margin Loan Model	Credit spread / (C)(D)	10 to 265 bps	170bps
		Margin Loan Model	Volatility skew / (C)(D)	3% to 4%	4%
		Margin Loan Model	Comparable price / (A)(D)	80% to 120%	100%
		Option Model	Volatility skew / (C)	0%	0%

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

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

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Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

LIABILITIES	Fair value \$millions	Valuation technique	Significant unobservable input(s) / sensitivity of the fair value to changes in the unobservable inputs	Range ⁽²⁾	Averages ⁽³⁾
Financial liabilities classified as held for trading:					
- Corporate and other debt:					
- Other debt	(39)	Option Model	At the money volatility / (A)	31%	31%
- Net derivative contracts ⁽¹⁾					
- Credit	6	Correlation Model	Credit correlation / (B)	30% to 65%	51%
		Comparable pricing	Comparable bond price / (C)(D)	12 to 99 points	58 points
		Comparable pricing	Cash Synthetic Basis / (C)(D)	2 to 5 points	4 points
- Equity ⁽³⁾	(754)	Option Model	At the money volatility / (C)(D)	16% to 57%	29%
			Volatility skew / (C)(D)	-3% to 0%	-1%
			Equity correlation / (C)(D)	40% to 99%	67%
			Equity Foreign exchange correlation / (C)(D)	-30% to 9%	-20%
- Interest rate ⁽⁴⁾	74	Option Model	Comparable bond price / (A)(D)	5 to 100 points	58, 65 points
			Inflation volatility / (A)(D)	77% to 86%	81%, 80%
			Interest rate / (A)(D)	0% to 1%	1%, 0%
			Net asset value / (A)(D)	\$0 to \$121	\$63
			Interest rate - Foreign exchange correlation / (A)(D)	3% to 63%	43%, 48%
			Interest rate curve correlation / (A)(D)	46% to 92%	74%, 80%
			Interest rate quanto correlation / (A)(D)	-11% to 34%	8%, 5%
			Interest rate volatility skew / (A)(D)	24% to 50%	33%, 28%
- Foreign exchange ⁽⁴⁾⁽⁵⁾	151	Option Model	Interest rate / (A)(D)	0% to 1%	1%, 0%
			Interest rate - Foreign exchange correlation / (A)(D)	3% to 63%	43%, 48%
			Interest rate curve correlation / (A)(D)	46% to 92%	74%, 80%
			Interest rate quanto correlation / (A)(D)	-11% to 34%	8%, 5%
			Interest rate volatility skew / (A)(D)	24% to 50%	33%, 28%
Financial liabilities designated at fair value through profit or loss:					
- Prepaid OTC contracts	(69)	Option Model	At the money volatility / (C)	14% to 40%	22%
		CDS model	Funding spread / (C)	96 to 147 bps	129 bps
- Other	(188)	Comparable pricing	Comparable bond price / (A)	99 to 101 points	101 points

(1) Net derivative contracts represent financial assets classified as held for trading – derivative contracts net of financial liabilities classified as held for trading – derivative contracts. In addition, there are other derivative contracts with a fair value of \$7 million not included within one of the major derivative categories.

(2) The ranges of significant unobservable inputs are represented in points, percentages or basis points. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point (bps) equals 1/100th of 1%, for example, 265 basis points would equal 2.65%.

(3) Amounts represent weighted averages except where simple averages and the median of the inputs are provided (see footnote 4 below). Weighted averages are calculated by weighting each input by the fair value of the respective financial instruments except for derivative instruments where inputs are weighted by risk.

(4) The data structure of the significant unobservable inputs used in valuing Interest rate contracts and certain Equity contracts may be in a multi-dimensional form, such as a curve or surface, with risk distributed across the structure. Therefore, a simple average and median, together with the range of data inputs, may be more appropriate measurements than a single point weighted average.

(5) Includes derivative contracts with multiple risks (i.e. hybrid products)

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

- d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)
- i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

The following provides a description of significant unobservable inputs included in the table above for all major categories of assets and liabilities:

- *Comparable bond price* – a pricing input used when prices for the identical instrument are not available. Significant subjectivity may be involved when fair value is determined using pricing data available for comparable instruments. Valuation using comparable instruments can be done by calculating an implied yield (or spread over a liquid benchmark) from the price of a comparable bond, then adjusting that yield (or spread) to derive a value for the bond. The adjustment to yield (or spread) should account for relevant differences in the bonds such as maturity or credit quality. Alternatively, a price-to-price basis can be assumed between the comparable instrument and bond being valued in order to establish the value of the bond. Additionally, as the probability of default increases for a given bond (i.e., as the bond becomes more distressed), the valuation of that bond will increasingly reflect its expected recovery level assuming default. The decision to use price-to-price or yield/spread comparisons largely reflects trading market convention for the financial instruments in question. Price-to-price comparisons are primarily employed for CMBS, CDOs, mortgage loans and distressed corporate bonds. Implied yield (or spread over a liquid benchmark) is utilised predominately for non-distressed corporate bonds, loans and credit contracts.
- *Correlation* – a pricing input where the payoff is driven by more than one underlying risk. Correlation is a measure of the relationship between the movements of two variables (i.e., how the change in one variable influences a change in the other variable). Credit correlation, for example, is the factor that describes the relationship between the probability of individual entities to default on obligations and the joint probability of multiple entities to default on obligations. The correlation ranges may be wide since any two underlying inputs may be highly correlated (either positively or negatively) or weakly correlated.
- *Credit spread* – the difference in yield between different securities due to differences in credit quality. The credit spread reflects the additional net yield an investor can earn from a security with more credit risk relative to one with less credit risk. The credit spread of a particular security is often quoted in relation to the yield on a credit risk-free benchmark security or reference rate, typically either U.S. Treasury or LIBOR.
- *EBITDA multiple / Exit multiple* – is the Enterprise Value to EBITDA ratio, where the Enterprise Value is the aggregate value of equity and debt minus cash and cash equivalents. The EBITDA multiple reflects the value of the company in terms of its full-year EBITDA, whereas the exit multiple reflects the value of the company in terms of its full year expected EBITDA at exit. Either multiple allows comparison between companies from an operational perspective as the effect of capital structure, taxation and depreciation/amortisation is excluded.
- *Funding spread* – the difference between the general collateral rate (which refers to the rate applicable to a broad class of U.S. Treasury issuances) and the specific collateral rate (which refers to the rate applicable to a specific type of security pledged as collateral, such as a municipal bond). Repurchase agreements are discounted based on collateral curves. The curves are constructed as spreads over the corresponding overnight index swap (“OIS”)/LIBOR curves, with the short end of the curve representing spreads over the corresponding OIS curves and the long end of the curve representing spreads over LIBOR.
- *Interest rate curve* – the term structure of interest rates (relationship between interest rates and the time to maturity) and a market’s measure of future interest rates at the time of observation. An interest rate curve is used to set interest rate derivative cash flows and is a pricing input used in discounting of any OTC derivative cash flow.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)

i. Quantitative information about and qualitative sensitivity of significant unobservable inputs (continued)

- *Volatility* – the measure of the variability in possible returns for an instrument given how much that instrument changes in value over time. Volatility is a pricing input for options and, generally, the lower the volatility, the less risky the option. The level of volatility used in the valuation of a particular option depends on a number of factors, including the nature of the risk underlying that option (e.g., the volatility of a particular underlying equity security may be significantly different from that of a particular underlying commodity index), the tenor and the strike price of the option.
- *Volatility skew* – the measure of the difference in implied volatility for options with identical underliers and expiry dates but with different strikes. The implied volatility for an option with a strike price that is above or below the current price of an underlying asset will typically deviate from the implied volatility for an option with a strike price equal to the current price of that same underlying asset.

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

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

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

The following tables present the sensitivity of the fair value of Level 3 financial assets and financial liabilities to reasonably possible alternative assumptions, providing quantitative information on the potential variability of the fair value measurement.

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Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

- d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)
- ii. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives (continued)

2013	Fair value \$millions	Effect of reasonably possible alternative assumptions	
		Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
Government debt securities	23	-	-
Corporate and other debt	714	21	(18)
Corporate equities	69	2	(4)
Financial assets designated at fair value through profit or loss:			
Prepaid OTC contracts	2	-	-
Customer loans	1,596	1	(2)
Available-for-sale financial assets:			
Corporate equities	58	-	-
Financial liabilities classified as held for trading:			
Corporate and other debt	47	-	-
Corporate equities	8	-	-
Net derivatives contracts ⁽¹⁾	530	108	(122)
Financial liabilities designated at fair value through profit or loss:			
Prepaid OTC contracts	69	-	-
Other	188	-	-

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

- d. Valuation of Level 3 financial assets and liabilities recognised at fair value on a recurring basis (continued)
- ii. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives (continued)

2012	Fair value \$millions	Effect of reasonably possible alternative assumptions	
		Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
Government debt securities	2	-	-
Corporate equities	113	45	(33)
Corporate and other debt	963	4	(4)
Financial assets designated at fair value through profit or loss:			
Prepaid OTC contracts	14	-	(13)
Structured notes	563	-	-
Available-for-sale financial assets:			
Corporate equities	38	1	(13)
Financial liabilities classified as held for trading:			
Corporate equities	3	-	-
Corporate and other debt	35	-	-
Net derivatives contracts ⁽¹⁾	1,232	132	(111)
Financial liabilities designated at fair value through profit or loss:			
Prepaid OTC contracts	134	2	(2)
Issued structured notes	1	-	-
Other	173	-	-

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

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30. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

e. Financial instruments valued using unobservable market data

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

	2013	2012
	Smillions	Smillions
At 1 January	559	536
New transactions	60	141
Amounts recognised in the consolidated income statement during the year	<u>(268)</u>	<u>(118)</u>
At 31 December	<u>351</u>	<u>559</u>

The consolidated statement of financial position categories 'Financial assets and financial liabilities classified as held for trading', 'Financial assets and financial liabilities designated at fair value through profit or loss', and 'Available-for-sale financial assets' include financial instruments whose fair value is based on valuation techniques using unobservable market data. The balance above predominantly relates to derivative contracts.

f. 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 consolidated 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.

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31. FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE

The table below presents the carrying value, fair value and fair value hierarchy category of certain financial assets and financial liabilities that are not measured at fair value in the consolidated statement of financial position.

Financial assets and financial liabilities not measured at fair value for which the carrying value is considered a reasonable approximation of fair value are excluded from the table below.

31 December 2013

	Carrying value \$millions	Fair value \$millions	Fair value measurement using:		
			Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant unobservable inputs (Level 3) \$millions
Financial liabilities					
Subordinated loans	7,906	8,117	-	8,117	-
Other payables	3,198	2,325	-	2,325	-

The fair value of subordinated loans has been determined based on the assumption that all subordinated loans are held to the latest repayment date, although the amounts outstanding are repayable at any time at the Group's option, subject to prior consent from the PRA. The carrying value as at 31 December 2012 was \$7,906 million and the fair value was \$6,663 million.

The fair value of other payables is determined based on current interest rates and credit spreads for debt instruments with similar terms and maturity. Also included in the consolidated statement of financial position is \$14,981 million of other payables where the carrying value is a reasonable approximation of fair value.

32. CAPITAL MANAGEMENT

The Group views capital as an important source of financial strength. It actively manages its capital in line with established policies and procedures which are consistent with the the Morgan Stanley Group. The Morgan Stanley Group manages its 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. It aims to adequately capitalise at a legal entity level whilst safeguarding that entity's ability to continue as a going concern and ensuring that it meets all regulatory capital requirements, so that it can continue to provide returns for the Morgan Stanley Group.

The capital managed by the Group broadly includes share capital, subordinated debt and reserves. In order to maintain or adjust its capital structure, the Group may adjust the amount of dividends paid, return capital to its shareholder, issue new shares, issue or repay subordinated debt or sell assets to reduce debt. During the year the Group issued new shares and repurchased its preference shares to further improve its capital.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

32. CAPITAL MANAGEMENT (CONTINUED)

Details of its managed capital are set out below:

	2013 Smillions	2012 Smillions
Ordinary share capital	11,464	8,414
Preference share capital	-	1,050
Subordinated debt	7,906	7,906
Reserves	4,116	3,987
	<u>23,486</u>	<u>21,357</u>

The Group is regulated by the PRA and as such is subject to minimum capital requirements. Management reviews the Group's capital levels on an ongoing basis to ensure compliance with these requirements. At a minimum, the Group must ensure that Capital Resources (share capital, subordinated debt, audited profit and loss and eligible reserves) are greater than the Capital Resource Requirement covering credit, market and operational risk. The Group complied with all of its regulatory capital requirements during the year.

Internal Capital Adequacy Assessment Process ("ICAAP")

MSI and all of its subsidiary undertakings (together "the MSI Group") prepares an Internal Capital Adequacy Assessment Process ("ICAAP") document in order to meet its obligations under the PRA and FCA prudential sourcebook rules for Banks, Building Societies and Investment Firms ("BIPRU"). The Company, as the main operating entity within the MSI Group is captured in this analysis. The MSI Group's Required Capital Framework captures risks not adequately covered under Pillar 1 and calculates an additional capital buffer required to absorb stress losses. It is used to ensure the MSI Group carries, or has access to, sufficient capital to support all its material risks. The framework is based on regional management's own risk assessment and is broadly consistent with the Morgan Stanley Group's Required Capital framework. The Required Capital framework is an internal capital adequacy measure, used to ensure that sufficient going concern capital is maintained after absorbing potential losses from extreme stress events where applicable, at a point in time. The Required Capital Framework will evolve over time in response to changes in the business and regulatory environment and to incorporate enhancements in modelling techniques.

The MSI Group ICAAP identifies and measures material risks, sets and assesses internal capital adequacy operating targets and limits that relate directly to risk through the Required Capital framework and the risk appetite defined by the PRA and assesses current and future capital adequacy under normal and stressed operating environments over the capital planning horizon.

The PRA reviews the ICAAP document through its Supervisory Review Process and issues an Individual Capital Guidance which sets the minimum level of regulatory capital for the MSI Group and the Company. In addition, the PRA sets a capital planning buffer which is available to support the MSI Group in a stressed market environment.

In December 2010, the Basel Committee on Banking Supervision published the final rules text on a comprehensive set of reform measures, developed to strengthen the regulation, supervision and risk management of the banking sector ("the Basel III Framework"). In July 2013, the EC published final legislation to implement these measures in Europe with an implementation date of 1 January 2014.

The Basel III Framework covers both microprudential and macroprudential elements. It sets out requirements for higher and better-quality capital, improved risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards (see note 26, "Liquidity and funding risk").

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Year ended 31 December 2013

32. CAPITAL MANAGEMENT (CONTINUED)

Basel II Pillar 3 disclosures

The Company is captured in the MSI Group Pillar 3 disclosures which allow investors and other market participants to understand capital adequacy, particular risk exposures and risk management processes of individual firms required by the UK implementation of Basel II. The 2012 Pillar 3 disclosure for the MSI Group can be found at www.morganstanley.com/investorrelations.

Capital Requirements Country-by-Country Reporting

The Company is included in the MSI consolidated disclosure in order to comply with the provisions of Statutory Instrument 2013 No.3118 Capital Requirements (Country-by-Country Reporting) Regulations 2013, which implements in the UK the requirements set out in Article 89 of the Capital Requirements Directive (Directive 2013/36/EU). These disclosures will be made available by 1 July 2014 on the Morgan Stanley website at www.morganstanley.com/investorrelations.

33. EMPLOYEE COMPENSATION PLANS

Equity-settled share-based compensation plans

- **Deferred restricted stock units**

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

During the year, Morgan Stanley granted 795,890 (2012: 720,821) of deferred restricted stock units to employees of the Group with a weighted average fair value per unit of \$22.52 (2012: \$18.21), based on the market value of Morgan Stanley shares at grant date.

- **Stock options**

Morgan Stanley has also granted stock option awards pursuant to several equity-based compensation plans. The plans provide for the deferral of a portion of certain key employees' incentive compensation with awards made in the form of stock options generally having an exercise price not less than the fair value of Morgan Stanley's common stock on the date of grant. Such stock option awards generally become exercisable over a three year period and expire seven to ten years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are generally similar to those in deferred restricted stock units.

There were no options granted during the year (2012: none).

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33. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Equity-settled share-based compensation plans (continued)

- Stock options (continued)

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

	2013		2012	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
	'000s	\$	'000s	\$
Options outstanding at 1 January	174	50.94	241	50.99
Expired during the year	(56)	38.64	(67)	51.11
Options outstanding and exercisable at 31 December	118	56.81	174	50.94

There were no options exercised during the year (2012: none).

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

	2013			2012		
	Number of options	Weighted average exercise price	Weighted average remaining life in years	Number of options	Weighted average exercise price	Weighted average remaining life in years
Range of exercise prices	'000s	\$		'000s	\$	
\$30.00 - \$39.99	-	-	-	52	36.22	-
\$40.00 - \$49.99	59	47.01	-	59	47.01	1.0
\$60.00 - \$69.99	59	66.73	3.0	63	66.73	4.0
Total	118	56.81	1.5	174	50.94	1.8

Other deferred compensation plans

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

Awards with a value of \$18 million (2012: \$28 million) have been granted to employees during the year and an expense of \$23 million (2012: \$30 million) has been recognised within 'Direct staff costs' in 'Other expense' in the consolidated income statement in relation to current and previous years' awards. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the consolidated statement of financial position, is \$18 million (2012: \$25 million).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

33. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Other deferred compensation plans (continued)

The Group economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation schemes is \$1 million (2012: \$1 million), and recognised within 'Financial liabilities classified as held for trading' is \$3 million (2012: \$3 million). The related profit recorded within 'Net gains on financial instruments classified as held for trading' for the year is \$1 million (2012: \$nil).

Plans operated by fellow Morgan Stanley undertakings

As described in note 7, the Group utilises staff employed by other Morgan Stanley Group undertakings and incurs management charges in respect of these employee services. These management charges include the costs of equity-based compensation provided to these employees.

34. POST EMPLOYMENT BENEFITS

Defined contribution plans

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

The defined contribution plans are as follows:

- Morgan Stanley Flexible Company Pension Plan (Amsterdam);
- MSII Offshore Retirement Benefit Plan IV, Dubai Section; and
- Morgan Stanley Asia Limited Retirement Benefit Plan (Taiwan)

The defined contribution pension charge in relation to the above schemes recognised within 'Staff costs' in 'Other expense' in the consolidated income statement was \$3 million for the year (2012: \$3 million) of which \$nil was accrued at 31 December 2013 (2012: \$nil).

Defined benefit plans

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

The defined benefits plans are as follows:

- Morgan Stanley & Co International plc Paris Branch IFC (Indemnités de Fin de Carrière);
- Morgan Stanley France (SAS) Leaving Indemnity Plan (Indemnités de Fin de Carrière);
- Morgan Stanley Asia (Taiwan) Limited Retirement Scheme;
- Morgan Stanley Asia (Taiwan) Limited Book Reserve Plan;
- Personalvorsorgestiftung der Bank Morgan Stanley AG Plan; and
- Morgan Stanley Dubai End of Service Gratuity

The defined benefit pension charge in relation to the above plans recognised in 'Staff costs' in 'Other expense' in the consolidated income statement was \$2 million for the year (2012: \$3 million). The cumulative amount of actuarial gains and losses recognised in other comprehensive income is a \$4 million gain (2012: \$2 million gain). A net liability of \$4 million (2012: \$5 million) is recognised in the Group's consolidated statement of financial position in respect of these plans.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

34. POST EMPLOYMENT BENEFITS (CONTINUED)

Plans operated by fellow Morgan Stanley undertakings

In addition to the above, along with a number of other Morgan Stanley Group companies, the Group incurs management charges from a fellow Morgan Stanley undertaking, Morgan Stanley UK Limited ("MSUK"), in respect of MSUK's employees' services. These management recharges include pension costs related to the Morgan Stanley UK Group Pension Plan ("the Plan"). The Plan is a defined contribution scheme with a closed defined benefit section.

Defined contribution scheme

The management recharge for the year in respect of the defined contribution scheme recognised within 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' in 'Other expense' was \$52 million (2012: \$57 million).

Defined benefit section

The defined benefit section of the Plan has been closed to new members since 1996. The Plan was previously open to permanent employees employed in the UK, and with the consent of the Trustees, other Morgan Stanley employees located outside the UK who had previously been employed in the UK and who at some point had been members of the Plan. The amount of pension benefit that a member is entitled to receive on retirement is dependent on years of service and salary at the time of closure of the Plan in 1996.

The Plan assets are held in a separate Trustee-administered fund to meet long-term pension liabilities. The Trustees of the fund are required to act in the best interest of the fund's beneficiaries. The appointment of Trustees to the Plan is determined by the Plan's trust documentation. MSUK has a policy that one third of Trustees should be nominated by members of the fund.

A full actuarial valuation of the defined benefit section of the Plan is conducted at least every three years. The most recent full actuarial valuation of the Plan was carried out at 31 December 2012.

The full actuarial valuation provides a funding basis for the Plan. The funding basis varies from the IAS 19 valuation as it is determined using assumptions reflective of the cost of securing the benefits built up in the Plan with an insurance company. The Trustees and MSUK have agreed that any funding shortfalls should be eliminated as quickly as MSUK can reasonably afford. The contributions are reviewed each year as part of the annual funding update and are increased or reduced as appropriate to eliminate the funding deficit by the end of the agreed recovery period.

There is no contractual arrangement for recharging the net defined benefit cost of the Plan as a whole measured in accordance with IAS 19. Accordingly, in line with IAS 19 the Group recognises its contribution payable for the period as an expense. On this basis, the management recharge for the year in respect of the defined benefit plan recognised within 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' in 'Other expense' was \$11 million (2012: \$10 million).

The full actuarial valuation at 31 December 2012 indicated a deficit on a funding basis of \$22 million. A schedule of contributions was agreed by the Trustees and MSUK on 31 October 2013 on the basis of funding deficit which, based upon the assumptions used is expected to eliminate the shortfall by 31 January 2015. MSUK expects to contribute \$11 million (2012: \$11 million) in the next financial year based upon the schedule of contributions agreed.

The Group's exposure to the Plan is limited to the management recharges from MSUK in respect of the contributions paid. These are recognised as an expense in the consolidated income statement.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

34. POST EMPLOYMENT BENEFITS (CONTINUED)

Plans operated by fellow Morgan Stanley undertakings (continued)

Defined benefit section (continued)

On an IAS 19 basis, the Plan has a surplus of scheme assets over liabilities. The full actuarial valuation as at 31 December 2012, adjusted as appropriate for the requirements of IAS 19, was updated by a qualified actuary at 31 December 2013 to allow for changes in market conditions and actuarial assumptions. The liabilities of the Plan are measured by discounting the best estimate of future cash flows to be paid out by the Plan using the projected unit method. Under this method, each participant's benefits under the Plan are attributed to years of service, taking into consideration the Plan's benefit allocation formula. For the defined benefit section of the Plan, accrual of future benefits ceased in 1996 and no further benefit has been attributed to service during subsequent reporting periods. The accumulated benefit obligation is therefore an actuarial measure of the present value of benefits for service already rendered and includes no assumption for future salary increases. An assumption for revaluation in deferment is built into the valuation of the scheme. This revaluation preserves the benefits accrued and prevents the benefit diminishing over time through the effects of inflation.

The following table provides a summary of the present value of the defined benefit obligation and fair value of plan assets under IAS 19:

	2013 \$millions	2012 \$millions
Present value of the funded defined benefit obligation	(198)	(206)
Fair value of plan assets	257	250
Surplus of the funded defined benefit plan	59	44
Impact of asset ceiling	(59)	(44)
Net asset	-	-

The asset ceiling restricts the surplus recognised on the MSUK Statement of Financial Position to the amount that is recoverable by MSUK.

Actuarial assumptions

The following table presents the principal actuarial assumptions used in the valuation of the Plan:

	2013 %	2012 %
Pre retirement discount rate	4.5	3.8
Post retirement discount rate	3.9	4.0
Inflation	3.6	3.0
Revaluation in deferment	2.6	2.3

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

34. POST EMPLOYMENT BENEFITS (CONTINUED)

Actuarial assumptions (continued)

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

	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
	Aged 65	Aged 45	Aged 65	Aged 45
31 December 2013				
UK	89.9	92.0	92.0	94.4
31 December 2012				
UK	89.5	92.3	92.0	95.0

Plan assets

MSUK and the Trustees, in consultation with their independent investment consultants and actuaries, determine the asset allocation targets based on their assessment of business and financial conditions, demographic and actuarial data, funding characteristics and related risk factors. Other relevant factors, including industry practices and long-term historical and prospective capital market returns, are also considered. The overall investment objective is expected to minimise the volatility of the Plan's surplus or deficit.

Specific risks which are managed through the asset allocation targets include:

- Interest rate and inflation risk – Plan liabilities will change in response to changes in interest rates and inflation. The policy is to hedge this risk as far as possible;
- Asset volatility – investment in asset classes such as equities gives rise to volatility in the value of the assets. The policy is to invest in asset classes which closely match the Plan's liabilities;
- Credit risk – any default or downgrade in instruments such as corporate bonds and money market instruments may result in losses. The policy is to partially mitigate this risk by investment in a range of different credit instruments via pooled funds;
- Liquidity risk – the liquidity of investments may change over time which may have an impact on the expected transaction costs. The Trustees and MSUK have reviewed the likely cash requirements of the Plan and are satisfied that the investment arrangements provide sufficient liquidity;
- Longevity risk – the longevity experience may differ from expectations and expectations may change over time. The purchase of annuities for pensioners mitigates a substantial portion of this risk;

In line with the above investment objectives, the Plan holds investments in a range of pooled investment vehicles of varying maturities intended to broadly reflect the expected liability profile of the Plan. The major categories and fair values of scheme assets at the end of the reporting period are set out below. All investments are quoted in an active market in both years.

	2013 \$millions	2012 \$millions
Investment funds:		
Cash funds	56	55
Corporate bond index funds	42	33
Government bond index funds:		
UK Gilt index funds	81	77
GBP fixed liability matching funds	78	85
	<u>257</u>	<u>250</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

35. RELATED PARTY DISCLOSURES

Parent and subsidiary relationships

Parent and ultimate controlling entity

On 12 December 2013, the Group's immediate parent undertaking changed from Morgan Stanley UK Group to Morgan Stanley Investments (UK) as a result of Morgan Stanley UK Group contributing its holding in the Company to Morgan Stanley Investments (UK). Morgan Stanley Investments (UK) is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.

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

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

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

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

	2013	2012
	\$millions	\$millions
Short-term employee benefits	29	28
Post-employment benefits	1	1
Share-based payments	40	43
Other long-term employee benefits	36	39
Termination benefits	3	-
	<u>109</u>	<u>111</u>

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

The Group incurred management recharges in respect of key management compensation in both the current and prior years.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

35. RELATED PARTY DISCLOSURES (CONTINUED)

Directors loans

Secured loan facilities may be provided to Directors on a discretionary basis. There were no facilities in place during 2013 (2012: one). The amount outstanding as at 31 December 2013 is \$nil (2012: \$nil).

In 2012 the maximum amount of credit available under this facility was \$1 million and credit could be drawn in US dollars or Sterling at interest rates of LIBOR plus 210 basis points and SONIA plus 175 bases points respectively. The total amounts drawn down and repaid during 2012 were \$1 million and \$1.8 million respectively.

Directors' remuneration

	2013 \$millions	2012 \$millions
Total emoluments of all Directors:		
Aggregate remuneration	5	4
Long term incentive schemes	10	11
	<u>15</u>	<u>15</u>
Disclosures in respect of the highest paid Director:		
Aggregate remuneration	1	2
Long term incentive schemes	3	3
	<u>4</u>	<u>5</u>

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

Directors who are employees of the Morgan Stanley Group are eligible for shares and share options of the parent company, Morgan Stanley, awarded under the Morgan Stanley Group's equity-based long-term incentive schemes. In accordance with Schedule 5 paragraph 1(3)(a) of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the above disclosures include neither the value of shares awarded, nor the gains made on exercise of share options. During the year under these incentive schemes no Directors exercised share options (2012: none) and six Directors received deferred stock unit awards in respect of qualifying services, including the highest paid Director (2012: six).

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

There are five Directors to whom retirement benefits are accruing under a money purchase scheme (2012: seven). In addition, three Directors have benefits accruing under a Morgan Stanley non-UK defined benefits scheme (2012: one).

Transactions with related parties

The Morgan Stanley Group conducts business for clients globally through a combination of both functional and legal entity organisational structures. Accordingly, the Group is closely integrated with the operations of the Morgan Stanley Group and enters into transactions with other Morgan Stanley Group undertakings on an arm's length basis for the purposes of utilising financing, trading and risk management, and infrastructure services. The nature of these relationships along with information about the transactions and outstanding balances is given below. The Group has not recognised any expense and has made no provision for impairment relating to the amount of outstanding balances from related parties (2012: \$nil).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2013

35. RELATED PARTY DISCLOSURES (CONTINUED)

Transactions with related parties (continued)

Funding

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

- *General funding*

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

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

	2013		2012	
	Interest \$millions	Balance \$millions	Interest \$millions	Balance \$millions
Amounts due from the Group's direct and indirect parent undertakings	39	495	45	1,837
Amounts due from other Morgan Stanley Group undertakings	95	1,836	121	3,318
	<u>134</u>	<u>2,331</u>	<u>166</u>	<u>5,155</u>
Amounts due to the Group's direct and indirect parent undertakings	171	5,198	234	4,324
Amounts due to other Morgan Stanley Group undertakings	336	10,609	342	13,182
	<u>507</u>	<u>15,807</u>	<u>576</u>	<u>17,506</u>

- *Subordinated loans*

The Group received a subordinated loan from another Morgan Stanley Group undertaking. Details of the terms of the loan, including the contractual maturity and the interest rate are shown in note 16. The interest rate is established by the Morgan Stanley Group Treasury function based on available market information at the time the loan is provided or subsequently amended.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

35. RELATED PARTY DISCLOSURES (CONTINUED)

Transactions with related parties (continued)

Trading and risk management

In the course of funding its business, the Group enters into collateralised financing transactions with other Morgan Stanley Group undertakings. All such transactions are entered into on an arm's length basis.

Details of the outstanding balances on such transactions and the related interest income/expense recognised in the consolidated income statement during the year are shown in the table below:

	2013		2012	
	Interest \$millions	Balance \$millions	Interest \$millions	Balance \$millions
Amounts due from other Morgan Stanley Group undertakings (restated)*	267	44,214	588	48,105
Amounts due to other Morgan Stanley Group undertakings (restated)*	502	23,145	794	50,640

*Details of the restatement are provided in note 2.

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

	2013 \$millions	2012 \$millions
Amounts due from the Group's direct and indirect parent undertakings on unsettled securities and derivative transactions	1,453	1,392
Amounts due from other Morgan Stanley Group undertakings on unsettled securities and derivative transactions	109,011	105,240
	<u>110,464</u>	<u>106,632</u>
Amounts due to the Group's direct and indirect parent undertakings on unsettled securities and derivative transactions	552	1,011
Amounts due to other Morgan Stanley Group undertakings on unsettled securities and derivative transactions	103,501	102,583
	<u>104,053</u>	<u>103,594</u>

The Group has received collateral of \$7,622 million (2012: \$5,366 million) from other Morgan Stanley Group undertakings and has pledged collateral of \$13,217 million (2012: \$9,123 million) to other Morgan Stanley Group undertakings to mitigate credit risk on exposures arising under derivatives contracts between the Group and other Morgan Stanley Group undertakings.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2013

35. RELATED PARTY DISCLOSURES (CONTINUED)

Transactions with related parties (continued)

Trading and risk management (continued)

In addition, the management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. For the year ended 31 December 2013, \$589 million (2012: \$638 million) was transferred to other Morgan Stanley Group undertakings relating to such policies and recognised in the consolidated income statement.

Infrastructure services

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

	2013		2012	
	Staff costs \$millions	Other services \$millions	Staff costs \$millions	Other services \$millions
Amounts recharged from the Group's direct and indirect parent undertakings	-	201	-	221
Amounts recharged from other Morgan Stanley Group undertakings	1,861	128	1,469	253
	<u>1,861</u>	<u>329</u>	<u>1,469</u>	<u>474</u>

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

Taxation

The Group has surrendered group relief to other members of the Morgan Stanley UK tax group for no cash consideration (see note 8).

Other related party transactions

The Company has received a guarantee from Morgan Stanley Investments (UK) (previously received from MSI), its immediate parent undertaking, to guarantee the obligations under derivative contracts of certain fellow Morgan Stanley Group undertakings to the Company. As at 31 December 2013, no call had been made by the Group under these arrangements.

MORGAN STANLEY & CO. INTERNATIONAL plc**Registered number: 2068222****COMPANY BALANCE SHEET****As at 31 December 2013**

	Note	2013 \$millions	Restated 2012 \$millions
FIXED ASSETS			
Tangible assets	3	4	4
Investments:			
- Available-for-sale financial assets	4	56	38
- Subsidiary undertakings	4	87	87
		<u>147</u>	<u>129</u>
CURRENT ASSETS			
Financial assets classified as held for trading (of which \$45,178 million (2012: \$42,457 million) were pledged to various parties)	5	332,603	347,714
Financial assets designated at fair value through profit or loss	6	7,673	7,591
Loans and receivables:			
- Debtors	7	170,337	202,807
- Cash at bank	8	11,969	11,255
Other assets	9	501	384
		<u>523,083</u>	<u>569,751</u>
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR			
Financial liabilities classified as held for trading	5	279,947	312,793
Financial liabilities designated at fair value through profit and loss	6	9,918	8,170
Financial liabilities at amortised cost	11	199,989	215,896
Other creditors	12	354	322
		<u>490,208</u>	<u>537,181</u>
NET CURRENT ASSETS		<u>32,875</u>	<u>32,570</u>
TOTAL ASSETS LESS CURRENT LIABILITIES		<u>33,022</u>	<u>32,699</u>
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Financial liabilities designated at fair value through profit and loss	6	3,028	3,860
Financial liabilities at amortised cost	11	14,486	15,448
PROVISIONS FOR LIABILITIES	13	29	82
NET ASSETS EXCLUDING PENSION LIABILITIES		<u>15,479</u>	<u>13,309</u>
Pension liability		2	4
NET ASSETS INCLUDING PENSION LIABILITY		<u>15,477</u>	<u>13,305</u>
CAPITAL AND RESERVES			
Called up share capital	14	11,464	9,464
Share premium account	15	513	513
Currency translation reserve	15	(44)	(58)
Available-for-sale reserve	15	5	5
Capital contribution reserve	15	3	3
Capital redemption reserve	15	1,399	1,399
Profit and loss account	15	2,137	1,979
SHAREHOLDERS' FUNDS		<u>15,477</u>	<u>13,305</u>

These financial statements were approved by the Board and authorised for issue on 23 April 2014.

Signed on behalf of the Board

Director  I PLENDERLEITH

The notes on pages 119 to 142 form an integral part of the financial statements.

Details of the restatement are provided in note 1(b).

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

1. ACCOUNTING POLICIES

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

a) Basis of preparation

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

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

b) Restatement of comparative amounts

In order to ensure consistency with the Group's financial statements, the Company's financial statements include a prior year adjustment relating to certain cash collateral on securities borrowed and cash collateral on securities loaned balances which were previously presented gross by an amount of \$11,570 million, but which do qualify for netting in the balance sheet under FRS 25 *Financial Instruments: Presentation*. This restatement resulted in reductions in cash collateral on securities borrowed and total assets, and in cash collateral on securities loaned and total liabilities, by \$11,570 million. There was no impact on the Company's net assets. Notes 7 and 11 have also been revised as a result of this restatement.

c) 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 Strategic report on pages 1 to 10.

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

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Company will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

d) 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 report and Directors' report are rounded to the nearest million US dollars (unless otherwise stated).

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

e) Foreign currencies

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

On disposal of a foreign operation, the related cumulative gain or loss in the 'Currency translation reserve' attributable to the equity holders of the Company is reclassified to the profit and loss account and recorded within gain/ (loss) on disposal.

f) Financial instruments

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

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

More information regarding these classifications is included below:

i) Financial instruments classified as held for trading

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

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

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

i) Financial instruments (continued)

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

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

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

From the date the transaction in a financial instrument designated at fair value 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. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at fair value through profit or loss (see note 1(g) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends are reflected in the profit and loss account in 'Net gains/(losses) on financial instruments designated at fair value through profit or loss'.

Transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the profit and loss account in 'Other expense'.

iii) Available-for-sale fixed asset investments

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

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

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

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

iv) Investments in subsidiary undertakings

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

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

On disposal of an investment in a subsidiary, the cumulative gain or loss is reclassified to the profit and loss account and reported in 'Gain/ (loss) on disposal of subsidiary'.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

f) Financial instruments (continued)

v) Loans and receivables and financial liabilities at amortised cost

Financial assets classified as loans and receivables are initially recognised on settlement date at fair value (see note 1(g) below) and subsequently measured at amortised cost less allowance for impairment. Interest is recognised in the profit and loss account in 'Interest income', using the effective interest 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 profit and loss account in 'Other expense'.

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

The effective interest 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.

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

g) Fair value of financial instruments

Fair value measurement

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

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

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, for example, the type of product, whether the product is new and not yet established in the marketplace, the liquidity of 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.

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.

Valuation techniques

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

Fair value for many cash and OTC contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity), as well as multiple inputs including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk.

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

g) Fair value of financial instruments (continued)

Valuation techniques (continued)

Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in its own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty's credit spreads is considered when measuring the fair value of assets. For OTC derivatives, the impact of changes in both the Company's and the counterparty's credit standing is considered when measuring fair value. In determining the expected exposure the Company simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party credit default swap ("CDS") spread data. Where CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. The Company also considers collateral held and legally enforceable master netting agreements that mitigate the Company's exposure to each counterparty.

Adjustments for model uncertainty are taken for positions where underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible. The Company generally subjects all valuations and models to a review process initially and on a periodic basis thereafter.

The Company may apply a concentration adjustment to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk exposure. Where possible, these adjustments are based on observable market information but in many instances significant judgement is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

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

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 to validate the fair value of the Company's financial instruments measured at fair value including those derived from pricing models. These control processes are designed to ensure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to ensure that the valuation approach utilised is appropriate and consistently applied and that the assumptions are reasonable.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

g) Fair value of financial instruments (continued)

Valuation process (continued)

The Company's control processes apply to all financial instruments, unless otherwise noted. These control processes include:

Model Review. VRG, in conjunction with the Market Risk Department and, where appropriate, the Credit Risk Management Department, both of which report to the Chief Risk Officer of the Morgan Stanley Group ("CRO"), independently review 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 ensure 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 model. Before trades are executed using new valuation models, those models are required to be independently reviewed. All of the Company's valuation models are subject to an independent annual VRG review.

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

VRG uses recently executed transactions, other observable market data such as exchange data, broker/ dealer quotes, third-party pricing vendors and aggregation services for validating the fair values of financial instruments generated using valuation models. VRG assesses the external sources and their valuation methodologies to determine if the external providers meet the minimum standards expected of a third-party pricing source. Pricing data provided by approved external sources 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 to ensure that the highest-ranked market data source is used to validate the business unit's fair value of financial instruments.

For financial instruments where the fair value is based on unobservable inputs, VRG reviews the business unit's valuation techniques to ensure these are consistent with market participant assumptions.

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

Review of Transactions where the valuation is based on unobservable inputs. VRG reviews the models and valuation methodology used to price all new material Level 3 transactions and both the FCG and Market Risk Department management must approve the fair value of the trade that is initially recognised.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

g) Fair value of financial instruments (continued)

Valuation process (continued)

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

Gains and losses on inception

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

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

h) Derecognition of financial assets and liabilities

The Company derecognises a financial asset only 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.

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

i) Impairment of financial assets

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

Impairment losses on available-for-sale financial assets are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value. Where there is evidence that the available-for-sale financial asset is impaired, the cumulative loss that had been previously recognised in total recognised gains and losses is reclassified from the 'Available-for-sale reserve' and recognised in the profit and loss account within 'Net gains/(losses) on fixed asset investments in available-for-sale financial assets'.

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

i) Impairment of financial assets (continued)

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 profit and loss account within 'Other expense' and are recognised against the carrying amount of the impaired asset on the balance sheet. Interest on the impaired asset continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset.

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

j) Fees and commissions

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

k) Tangible fixed assets

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

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

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

Leasehold improvements, including reinstatement assets - shorter of remaining lease term and 25 years

Fixtures, fittings and equipment - 3 to 8 years

l) Operating leases

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

m) Taxation

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

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

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

n) Employee compensation plans

i) Equity-settled share-based compensation plans

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

ii) Other deferred compensation plans

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

1. ACCOUNTING POLICIES (CONTINUED)

o) Retirement benefits

The Company operates defined contribution schemes and defined benefit pension schemes.

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

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

p) Cash flow statement

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

2. PROFIT FOR THE YEAR

As permitted by section 408 of the Companies Act 2006, the Company has elected not to present its own profit and loss account for the period. The Company reported a profit after tax of \$247 million for the year ended 31 December 2013 (2012: \$39 million).

3. TANGIBLE FIXED ASSETS

	Leasehold improvements \$millions	Fixtures, fittings and equipment \$millions	Total \$millions
Cost			
At 1 January 2013	18	13	31
Additions	-	1	1
At 31 December 2013	<u>18</u>	<u>14</u>	<u>32</u>
Depreciation			
At 1 January 2013	15	12	27
Charge for the year	<u>1</u>	<u>-</u>	<u>1</u>
At 31 December 2013	<u>16</u>	<u>12</u>	<u>28</u>
Net book value			
At 31 December 2012	<u>3</u>	<u>1</u>	<u>4</u>
At 31 December 2013	<u>2</u>	<u>2</u>	<u>4</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

4. FIXED ASSET INVESTMENTS

Fixed asset investments classified as available-for-sale

Fixed asset investments that are categorised as available-for-sale consist of corporate equities, of which \$2 million are listed investments (2012: \$2 million).

Movements in fixed asset investments classified as available-for-sale during the year are as follows:

	2013 Smillions	2012 Smillions
At 1 January	38	67
Additions	25	-
Changes in fair value recognised in the 'available-for-sale reserve'	4	30
Disposals and other settlements	(11)	(59)
At 31 December	<u>56</u>	<u>38</u>

Fixed asset investments in subsidiary undertakings

	Subsidiary undertakings Smillions	Total Smillions
Cost		
At 1 January 2013	<u>1,081</u>	<u>1,081</u>
At 31 December 2013	<u>1,081</u>	<u>1,081</u>
Impairment provisions		
At 1 January 2013	<u>(994)</u>	<u>(994)</u>
At 31 December 2013	<u>(994)</u>	<u>(994)</u>
Net book value		
At 31 December 2012	<u>87</u>	<u>87</u>
At 31 December 2013	<u>87</u>	<u>87</u>

Details of the significant subsidiary undertakings are provided in note 13 of the consolidated financial statements. A full list of the Company's subsidiary undertakings will be annexed to the Company's next annual return and filed with the Registrar of Companies.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2013

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

Financial assets and financial liabilities classified as held for trading are summarised as follows:

	2013		2012	
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
Fair value				
Derivative financial instruments (listed and OTC):				
- Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	189,554	172,939	229,713	221,148
- Foreign exchange forward contracts and options	12,431	12,555	9,668	9,420
- Equity securities contracts (including equity swaps, warrants and options)	59,606	64,813	38,399	42,324
- Commodity forwards, options and swaps	2,502	2,814	4,445	4,652
	<u>264,093</u>	<u>253,121</u>	<u>282,225</u>	<u>277,544</u>
Government debt securities	9,703	8,805	18,153	17,009
Corporate and other debt	11,434	2,616	9,851	2,092
Corporate equities	<u>47,373</u>	<u>15,405</u>	<u>37,485</u>	<u>16,148</u>
Total financial instruments classified as held for trading	<u>332,603</u>	<u>279,947</u>	<u>347,714</u>	<u>312,793</u>

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

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

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

	2013		2012	
	Assets \$millions	Liabilities \$millions	Assets \$millions	Liabilities \$millions
Fair value				
Prepaid OTC contracts	3,482	2,578	4,310	3,174
Corporate loans	1,882	-	1,117	-
Issued structured notes	-	1,150	-	1,390
Other financial assets and liabilities	2,309	9,218	2,164	7,466
Total financial instruments designated at fair value through profit or loss	7,673	12,946	7,591	12,030

There are no terms and conditions of any financial asset or liability designated at fair value through profit or loss that may individually significantly affect the amount, timing and certainty of future cash flows for the Company.

7. DEBTORS

	2013 \$millions	2012 \$millions
Debtors classified within loans and receivables at amortised cost		
Trade debtors:		
- External counterparties	44,516	47,254
- Morgan Stanley Group undertakings	28,370	18,908
Securities purchased under agreements to resell and cash collateral on securities borrowed:		
- External counterparties	48,875	71,410
- Morgan Stanley Group undertakings (restated)*	46,666	59,741
Other amounts due from Morgan Stanley Group undertakings	1,910	5,488
Other debtors classified within loans and receivables	-	6
	170,337	202,807

*Details of the restatement are provided in note 1(b).

8. CASH AT BANK

Included within 'Cash at bank' is an amount of \$8,267 million (2012: \$7,480 million) which represents segregated client money, held in accordance with the FCA's Client Money Rules, and an amount of \$358 million (2012: \$209 million) which represents other client money.

9. OTHER ASSETS

	2013 \$millions	2012 \$millions
Deferred taxation (see note 10)	78	75
Corporation tax recoverable	221	159
Prepayments and accrued income	202	150
	501	384

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

10. DEFERRED TAX

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

	2013		2012	
	Asset \$millions	Liability \$millions	Asset \$millions	Liability \$millions
Accelerated capital allowances	5	-	5	-
Deferred compensation	8	-	10	-
Deferred interest	55	-	45	-
Other timing differences	10	(2)	15	(3)
	<u>78</u>	<u>(2)</u>	<u>75</u>	<u>(3)</u>

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

	2013		2012	
	Asset \$millions	Liability \$millions	Asset \$millions	Liability \$millions
At 1 January	75	(3)	31	(3)
Amounts recognised in the profit and loss account:				
- Current year timing differences	18	-	51	-
Amounts recognised in equity through the statement of total recognised gains and losses	(2)	-	(2)	-
Future tax charges on transitional accounting adjustments	-	1	-	-
- Prior year timing differences	(3)	-	-	-
Impact of change in UK Corporation tax rate	(10)	-	(5)	-
At 31 December	<u>78</u>	<u>(2)</u>	<u>75</u>	<u>(3)</u>

Finance Act 2013 enacted reductions in the UK corporation tax rate to 21% with effect from 1 April 2014 and 20% with effect from 1 April 2015. This overall rate reduction to 20% has had an impact on the Company's deferred tax balance as indicated above.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2013

11. FINANCIAL LIABILITIES AT AMORTISED COST

	2013 Smillions	2012 Smillions
Financial liabilities at amortised cost falling due within one year		
Bank loans and overdrafts	16	16
Trade creditors:		
- External counterparties	78,863	69,067
- Morgan Stanley Group undertakings	18,922	14,634
Securities sold under agreements to repurchase and cash collateral on securities loaned:		
- External counterparties	58,182	48,495
- Morgan Stanley Group undertakings (restated)*	30,946	70,574
Other amounts owing to Morgan Stanley Group undertakings	11,963	13,057
Other financial liabilities	1,097	53
	<u>199,989</u>	<u>215,896</u>
Financial liabilities at amortised cost falling due after more than one year		
Financial instruments issued:		
- Subordinated loans	7,906	7,906
Securities sold under agreements to repurchase and cash collateral on securities loaned:		
- External counterparties	2,146	4,325
Other amounts owing to Morgan Stanley Group undertakings	3,198	3,217
Other financial liabilities	1,236	-
	<u>14,486</u>	<u>15,448</u>
Total financial liabilities at amortised cost	<u>214,475</u>	<u>231,344</u>

*Details of the restatement are provided in note 1(b).

Included within 'Other amounts owing to Morgan Stanley Group undertakings' falling due within one year are amounts of \$7,594 million (2012: \$5,415 million) representing cash collateral received as security for open trading positions held with other Morgan Stanley Group undertakings.

Total financial liabilities at amortised cost of \$11,104 million (2012: \$11,123 million), included in the above, fall due for payment after five years from the balance sheet date. This consists of subordinated loans of \$7,906 million (2012: \$7,906 million) and other loan amounts owing to Morgan Stanley Group undertakings of \$3,198 million (2012: \$3,217 million). Details of terms relating to the loans are set out in the table below.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2013

11. FINANCIAL LIABILITIES AT AMORTISED COST (CONTINUED)

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

Counterparty	Repayment Date	Interest Rate	2013 \$millions	2012 \$millions
Morgan Stanley UK Financing I LP	31 October 2025	LIBOR ⁽¹⁾ plus 1.475%	7,906	7,906
Great St. Helen Finance Limited	31 May 2020	Canadian dollar proxy related rate ⁽²⁾	1,007	1,076
Morgan Stanley UK Financing III LP	31 December 2030	US dollar proxy related rate ⁽²⁾	2,191	2,141
			<u>11,104</u>	<u>11,123</u>

(1) London Interbank Offered Rate ("LIBOR"). On 11 December 2013 the interest rate was amended from LIBOR plus 1.25% to LIBOR plus 1.475%.

(2) Proxy 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 Morgan Stanley Group incurs in funding its business.

The amount outstanding under the subordinated loan agreement is repayable at any time at the Company's option, subject to two business days' notice to the lender and at least one month's notice to the PRA, which has the right under the agreement to refuse consent to repayment.

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

12. OTHER CREDITORS

	2013 \$millions	2012 \$millions
Amounts falling due within one year		
Corporation tax payable	169	156
Deferred tax (see note 10)	2	3
Accruals and deferred income	<u>183</u>	<u>163</u>
	<u>354</u>	<u>322</u>

13. PROVISIONS FOR LIABILITIES

	Property \$millions	Litigation \$millions	Other \$millions	Total \$millions
At 1 January 2013	3	79	-	82
Additional provisions	-	-	25	25
Provisions utilised	-	(78)	-	(78)
At 31 December 2013	<u>3</u>	<u>1</u>	<u>25</u>	<u>29</u>

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Year ended 31 December 2013

13. PROVISIONS FOR LIABILITIES (CONTINUED)

Property

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Tangible fixed assets' (note 4).

Litigation matters

In addition to the matters described below, in the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company's business, and involving, among other matters, sales and trading activities, financial products or offerings sponsored, underwritten or sold by the Company, and accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

The Company contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the financial statements and the Company can reasonably estimate the amount of that loss, the Company accrues the estimated loss by a charge to the profit and loss account. The Company expects future litigation accruals in general to continue to be elevated and the changes in accruals from period to period may fluctuate significantly, given the current environment regarding government investigations and private litigation affecting global financial services firms, including the Company.

For certain legal proceedings, the Company cannot predict with certainty if, how or when such proceedings or investigations will be resolved or what the eventual settlement, fine, penalty or other relief, if any, may be, particularly for proceedings and investigations where the factual record is being developed or contested or where plaintiffs or government entities seek substantial or indeterminate damages, restitution, disgorgement or penalties. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages or other relief, and by addressing novel or unsettled legal questions relevant to the proceedings or investigations in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for a proceeding or investigation.

For certain other legal proceedings, the Company can estimate reasonably possible losses, additional losses, ranges of loss or ranges of additional loss in excess of amounts accrued, but does not believe, based on current knowledge and after consultation with counsel, that such losses will have a material adverse effect on the Company's financial statements as a whole, although the outcome of such proceedings could be material to the Company's operating results and cash flows for a particular period depending on, among other things, the level of the Company's revenues or income for such period.

Over the last several years, the level of litigation and investigatory activity (both formal and informal) by government and self-regulatory agencies has increased materially in the financial services industry. As a result, the Company expects that it may become the subject of increase claims for damages and other relief and, while the Company has identified below certain proceedings that the Company believes to be material, individually or collectively, there can be no assurance that additional material losses will not be incurred from claims that have not yet been asserted or are not yet determined to be material.

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NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

13. PROVISIONS FOR LIABILITIES (CONTINUED)

Litigation matters (continued)

On 25 August 2008, the Morgan Stanley Group, the Company and two ratings agencies were named as defendants in a purported class action related to securities issued by a structured investment vehicle ("SIV") called Cheyne Finance plc and Cheyne Finance LLC (together, the "Cheyne SIV"). The case is styled *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.* and is pending in the United States District Court for the Southern District of New York ("SDNY"). The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. The plaintiffs currently assert allegations of aiding and abetting fraud and negligent misrepresentation relating to approximately \$852 million of securities issued by the Cheyne SIV. The plaintiffs' motion for class certification was denied in June 2010. The court denied the Morgan Stanley Group's and the Company's motion for summary judgment on the aiding and abetting fraud claim in August 2012. On 30 November 2012, the Morgan Stanley Group and the Company filed a motion for summary judgment on the negligent misrepresentation claim. On 24 April 2013, the Morgan Stanley Group and the Company reached an agreement to settle this matter. On 26 April 2013, the court dismissed the action with prejudice. The settlement does not cover certain claims that were previously dismissed. On 23 May 2013, certain parties in *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.* filed a notice of appeal as to certain claims dismissed from the matter prior to the settlement by the remaining parties.

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Company and another Morgan Stanley Group undertaking, which is styled *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated* and is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a \$275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Company misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Company knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately \$228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional \$12 million, punitive damages, equitable relief, fees and costs. On 10 March 2011, the Company filed its answer to the complaint.

On 25 October 2010, the Company, other Morgan Stanley Group undertakings and Pinnacle Performance Limited, a special purpose vehicle ("SPV"), were named as defendants in a purported class action related to securities issued by the SPV in Singapore, commonly referred to as Pinnacle Notes. The case is styled *Ge Dandong, et al. v. Pinnacle Performance Ltd., et al.* and is pending in the Southern District of New York ("SDNY"). An amended complaint was filed on 22 October 2012. The court denied defendants' motion to dismiss the amended complaint on 22 August 2013 and granted class certification on 17 October 2013. On 30 October 2013, defendants filed a petition for permission to appeal the court's decision granting class certification. On 31 January 2014, plaintiffs filed a second amended complaint. The second amended complaint alleges that the defendants engaged in a fraudulent scheme to defraud investors by structuring the Pinnacle Notes to fail and benefited subsequently from the securities' failure. In addition, the second amended complaint alleges that the securities' offering materials contained material misstatements or omissions regarding the securities' underlying assets and the alleged conflicts of interest between the defendants and the investors. The second amended complaint asserts common law claims of fraud, aiding and abetting fraud, fraudulent inducement, aiding and abetting fraudulent inducement, and breach of the implied covenant of good faith and fair dealing. Plaintiffs seek damages of approximately \$138.7 million, rescission, punitive damages, and interest.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

13. PROVISIONS FOR LIABILITIES (CONTINUED)

Litigation matters (continued)

On 1 July 2013, the European Commission ("EC") issued a Statement of Objections ("SO") addressed to twelve financial firms (including the Company), the International Swaps and Derivatives Association, Inc. ("ISDA") and Markit Group Limited ("Markit") and various other Morgan Stanley Group undertakings alleging that, between 2006 and 2009, the recipients breached EU competition law by taking and refusing to take certain actions in an effort to prevent the development of exchange traded CDS products. The SO indicates that the EC plans to impose remedial measures and fines on the recipients. The Company, other Morgan Stanley Group undertakings and the other recipients filed a response to the SO on 21 January 2014. A Morgan Stanley group undertaking and others have also responded to an investigation by the Antitrust Division of the United States Department of Justice related to the CDS market.

Other

Other includes a provision for foreign withholding taxes that the Company may be required to settle on behalf of clients in relation to certain stock loan transactions. The amount of the provision reflects the most likely estimate within an identified range of possible outcomes.

14. CALLED UP SHARE CAPITAL

Shares classified as equity

	2013 \$millions	2012 \$millions
Allotted and fully paid:		
9,934,105,148 (2012: 6,884,105,148) ordinary shares of \$1 each	9,934	6,884
17,615,107 ordinary shares of £1 each	30	30
1,500,000,000 Class A non-voting ordinary shares of \$1 each	1,500	1,500
Nil (2012: 50,000,000) Class C non-redeemable non-cumulative preference shares of \$1 each	-	50
Nil (2012: 2,500,000,000) Class D1 non-redeemable non-cumulative preference shares of \$0.4 each	-	1,000
	<u>11,464</u>	<u>9,464</u>
Voting rights:		
Ordinary shares of \$1 and £1 each	100%	70%
Class A non-voting ordinary shares of \$1 each	Non-voting	Non-voting
Class C non-redeemable non-cumulative preference shares of \$1 each	-	20%
Class D1 non-redeemable non-cumulative preference shares of \$0.4 each	-	10%
	<u>100%</u>	<u>100%</u>

Equity shares

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

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

On 5 December 2013 the Company declared a dividend of \$88 million on the Class D1 preference shares and a dividend of \$1 million on the Class C preference shares.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2013

14. CALLED UP SHARE CAPITAL (CONTINUED)

Equity shares (continued)

During December 2013 the Company entered into the following transactions:

- On 12 December 2013 1,050,000,000 ordinary shares of \$1 each were issued at par to the Company's immediate parent undertaking pursuant to a Share Purchase and Buy Back Agreement. The proceeds were used to buy back and cancel all of the Company's Class C and Class D1 non-redeemable non-cumulative preference shares.
- On 18 December 2013 2,000,000,000 ordinary shares of \$1 each were issued at par, to the Company's immediate parent undertaking for cash consideration.

15. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES

	Called up share capital	Share premium account	Currency translation reserve	Available- for-sale reserve	Capital contribution reserve	Capital redemption reserve	Profit and loss account	Total
	Smillions	Smillions	Smillions	Smillions	Smillions	Smillions	Smillions	Smillions
At 1 January 2012	9,464	513	(77)	21	3	1,399	1,944	13,267
Total recognised gains and losses	-	-	19	(16)	-	-	36	39
Dividends	-	-	-	-	-	-	(1)	(1)
At 1 January 2013	9,464	513	(58)	5	3	1,399	1,979	13,305
Total recognised gains and losses	-	-	14	-	-	-	245	259
Remeasurement of defined benefit liability	-	-	-	-	-	-	2	2
Dividends (see note 14)	-	-	-	-	-	-	(89)	(89)
Ordinary shares issued (see note 14)	3,050	-	-	-	-	-	-	3,050
Preference shares repurchased (see note 14)	(1,050)	-	-	-	-	-	-	(1,050)
At 31 December 2013	11,464	513	(44)	5	3	1,399	2,137	15,477

Reserves

Share premium

The 'Share premium reserve' comprises the capital raised in an issue of shares that exceeds the nominal value of the shares.

Currency translation reserve

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

Available-for-sale reserve

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

Capital contribution reserve

The 'Capital contribution reserve' comprises of contributions of capital received from the Company's parent company.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2013

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

Reserves (continued)

Capital redemption reserve

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

16. COMMITMENTS AND CONTINGENCIES

During the next year, the Company is committed to pay \$6 million (2012: \$5 million) in respect of operating leases as follows:

	Land and buildings	
	2013	2012
	\$millions	\$millions
Annual commitments under operating leases expiring:		
- Within one year	2	2
- In two to five years	2	1
- After more than five years	2	2
	<u>6</u>	<u>5</u>

17. EMPLOYEE COMPENSATION PLANS

Equity-settled share-based compensation plans

- **Deferred restricted stock units**

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

During the year, Morgan Stanley granted 450,584 units (2012: 436,384 units) of deferred restricted stock units to employees of the Company with a weighted average fair value per unit of \$22.52 (2012: \$18.19), based on the market value of Morgan Stanley shares at grant date.

- **Stock options**

Morgan Stanley has also granted stock option awards pursuant to several equity-based compensation plans. The plans provide for the deferral of a portion of certain key employee's incentive compensation with awards made in the form of stock options generally having an exercise price not less than the fair value of Morgan Stanley's common stock on the date of grant. Such stock option awards generally become exercisable over a three year period and expire seven to ten years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are generally similar to those in deferred restricted stock units.

There were no options granted during the year (2012: none).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2013

17. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Equity-settled share-based compensation plans (continued)

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

	2013		2012	
	Number of options '000s	Weighted average exercise price \$	Number of options '000s	Weighted average exercise price \$
Options outstanding at 1 January	61	52.01	102	52.60
Expired during the year	(19)	43.41	(41)	53.48
Options outstanding and exercisable at 31 December	42	55.88	61	52.01

There were no options exercised during the year (2012: none).

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

	2013			2012		
	Number of options '000s	Weighted average exercise price \$	Weighted average remaining life in years	Number of options '000s	Weighted average exercise price \$	Weighted average remaining life in years
Range of exercise prices						
\$30.00 - \$39.99	-	-	-	14	36.22	-
\$40.00 - \$49.99	23	46.73	0.1	23	46.73	1.1
\$60.00 - \$69.99	19	66.73	3.0	24	66.73	3.8
Total	42	55.88	1.4	61	52.01	1.9

Other deferred compensation plans

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

Awards with a value of \$10 million (2012: \$16 million) have been granted to employees during the year and an expense of \$13 million (2012: \$19 million) has been recognised within 'Staff costs' in 'Other expense' in the profit and loss account in relation to the current and previous years' awards. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the balance sheet, is \$8 million (2012: \$13 million).

The Company economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation schemes is \$nil (2012: \$1 million), and recognised within 'Financial liabilities classified as held for trading' is \$2 million (2012: \$2 million). The related profit or loss recorded within 'Net gains/(losses) on financial instruments classified as held for trading' for the year is \$nil (2012: \$nil).

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NOTES TO THE COMPANY FINANCIAL STATEMENTS

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18. RETIREMENT BENEFITS

Defined contribution plans

The Company operates two Morgan Stanley defined contribution plans, which require contributions made to funds held separately from the assets of the Company, under the control of a Trustee.

The defined contribution plans are as follows:

- Morgan Stanley Flexible Company Pension Plan (Amsterdam)
- MSII Offshore Retirement Benefit Plan IV, Dubai Section

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

The defined contribution pension charge recognised within 'Staff costs' in 'Other expense' in the profit and loss account was \$2 million for the year (2012: \$2 million) of which \$nil was accrued at 31 December 2013 (2012: \$nil).

Defined benefit plans

The Company also operates defined benefit plans, which provide pension benefits that are based on length of service and salary. The Group's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations.

The defined benefits plans are as follows:

- Morgan Stanley & Co International plc Paris Branch IFC (Indemnités de Fin de Carrière)
- Personalvorsorgestiftung der Bank Morgan Stanley AG Plan
- Morgan Stanley Dubai End of Service Gratuity

A net liability of \$2 million (2012: \$4 million) is recognised in the balance sheet in respect of these plans.

19. RELATED PARTY TRANSACTIONS

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

20. PARENT UNDERTAKINGS

The ultimate parent undertaking and controlling entity and the largest group of which the Company is a member and for which group financial statements are prepared is Morgan Stanley. Morgan Stanley is incorporated in the state of Delaware, the United States of America and copies of its financial statements can be obtained from www.morganstanley.com/investorrelations.

On 12 December 2013, the Company's immediate parent undertaking changed from Morgan Stanley UK Group to Morgan Stanley Investments (UK) as a result of Morgan Stanley UK Group contributing its holding in the Company to Morgan Stanley Investments (UK). Morgan Stanley Investments (UK) is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.

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