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MORGAN STANLEY & CO. INTERNATIONAL plc

Half-yearly financial report

30 June 2014

MORGAN STANLEY & CO. INTERNATIONAL plc

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MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT REPORT

The Directors present their interim management report and the condensed consolidated financial statements (“Interim Financial Statements”) of Morgan Stanley & Co. International plc (the “Company”) and all of its subsidiary undertakings (together the “Group”), for the six month period ended 30 June 2014. This interim management report has been prepared for the Group as a whole and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiary undertakings when viewed as a whole.

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

RESULTS AND DIVIDENDS

The Group made a profit after tax in the six month period to 30 June 2014 of \$234 million (30 June 2013: \$192 million loss). No interim dividends were paid or declared (30 June 2013: \$nil).

PRINCIPAL ACTIVITY

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions. There have not been any changes in the Group’s principal activity in the period under review. On 20 December 2013, a Purchase Agreement was entered into between Morgan Stanley and Rosneft Oil Company (“Rosneft”) pursuant to which the Morgan Stanley Group will sell its global merchanting unit of its commodities division to Rosneft. The transaction is subject to approvals and other customary conditions and is expected to close in the second half of 2014. As part of this transaction the merchanting unit operated within the Company and Norwegian Energy Limited, a subsidiary of the Group, will be sold.

During the six month period ended 30 June 2014 the Company operated branches in the Dubai International Financial Centre, France, Korea, the Netherlands, New Zealand, Poland, the Qatar Financial Centre and Switzerland.

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.

REGULATION

The Company is authorised by the Prudential Regulation Authority (“PRA”) and regulated by the PRA and the Financial Conduct Authority (“FCA”).

BUSINESS REVIEW

During the six month period ended 30 June 2014, global market and economic conditions remained on an overall upward trend since the end of 2013. The US economy continued to show signs of growth during the six month period ended 30 June 2014, despite a decline in real gross domestic product in the first quarter of the year. The US employment situation continued to improve as evidenced by the decline in the unemployment rate. Inflation remained at historically low levels. The Eurozone economy continued its moderate recovery from a deep recession, but monetary and credit growth remained subdued. By contrast, the UK had a stronger-than-expected recovery and the second quarter of 2014 marked its strongest calendar

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

quarter in four years. Japan experienced stronger growth despite a drop in consumer spending resulting from a rise in sales tax. In China, the government continued reforms to change the structure of the Chinese economy with the objective to maintain its current high growth rate. Elsewhere, emerging markets have experienced considerable volatility resulting in part from the Federal Reserve's reduction of quantitative easing. Major European equity market indices were generally higher at the end of the six month period ended 30 June 2014 compared with the start of the period with Euro-area gross domestic product continuing to grow modestly during 2014. To further stimulate economic activity, the European Central Bank lowered its benchmark interest rate from 0.25% to a record low 0.15% during the six month period ended 30 June 2014, despite persistently low inflation. The euro-area unemployment rate decreased to 11.5% at 30 June 2014, from 12% at 31 December 2013. At 30 June 2014, the Bank of England's ("BOE") benchmark interest rate was 0.5%, which was unchanged from 31 December 2013. The BOE also remained committed to an asset purchase programme of £375 billion, also unchanged from 31 December 2013.

Overview of 2014 interim financial results

The condensed consolidated income statement for the six month period to 30 June 2014 is set out on page 13. The Group reported a gain after tax for the six month period to 30 June 2014 of \$234 million compared to a loss after tax of \$192 million for the six month period to 30 June 2013. Included in the result for the six month period to 30 June 2013 was a net currency translation loss on disposal of subsidiaries of \$151 million resulting from a reclassification from the "Currency translation reserve" to the condensed consolidated income statement (see note 11). This reclassification did not impact 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', 'Interest income', 'Interest expense' and 'Other income' ("aggregate revenues"). Aggregate revenues for the six month period ended 30 June 2014 increased by 23% to \$2,512 million compared to \$2,050 million for the six month period ended 30 June 2013.

Revenues increased during the period across all key business lines, with the biggest drivers being within equity sales and trading and fixed income and commodities sales and trading.

The largest revenue increases within equity sales and trading were in prime brokerage and cash equities due to increased trading volumes. Equity revenues include the impact of the release of day one gains from the unwind of trades where valuation techniques include unobservable market data.

The increase in fixed income and commodities sales and trading was driven by increased revenues from credit corporates and interest rate derivatives. This was partially offset by decreased revenues from foreign exchange trading.

Other expense increased from \$2,035 million for the six months ended 30 June 2013 to \$2,150 million for the six month period ended 30 June 2014. The increase in expense is spread across a range of expense lines including compensation related expenses, professional fees, brokerage fees and management charges from other Morgan Stanley Group undertakings.

The Group's tax expense for the six month period ended 30 June 2014 was \$128 million compared to \$56 million for the six month period ended 30 June 2013. This represents an effective tax rate of 35.4%, which is higher than the average standard rate of UK corporation tax of 21.49%. See note 2 for further details.

The condensed consolidated statement of financial position presented on page 16 reflects decreases in the Group's total assets and total liabilities of \$48,311 million and \$48,561 million respectively, representing decreases of 9% as at 30 June 2014 when compared to 31 December 2013. The decrease in total assets is driven by a decrease of \$65,443 million in financial assets classified as held for trading, partially offset by an increase of \$19,620 million in trade receivables. The decrease in total liabilities is driven by decreases in financial liabilities classified as held for trading of \$52,385 million and securities sold under agreement to repurchase of \$13,287 million, partially offset by an increase in trade payables of \$20,233 million.

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

Overview of 2014 interim financial results (continued)

The decrease in both financial assets and liabilities classified as held for trading is driven by a decrease in derivative assets and liabilities due mainly to additional counterparty netting following revision to settlement procedures and restructuring of trades as the Group's management continues to focus on reducing its total balance sheet position (see note 3). The increase in trade receivables and payables is due to an increase in securities pending settlement due to increased trading volumes at 30 June 2014 compared to 31 December 2013.

The condensed consolidated statement of cash flows presented on page 17 shows a net decrease in cash and cash equivalents of \$552 million during the six month period to 30 June 2014 (six month period to 30 June 2013: net increase of \$1,095 million). Net cash flows used in operating activities were \$479 million (six month period to 30 June 2013: \$538 million). Interest paid on subordinated debt was \$68 million (six month period to 30 June 2013: \$61 million). Excluding segregated client funds, the net decrease in cash and cash equivalents for the six month period to 30 June 2014 was \$1,004 million (six month period to 30 June 2013: net increase of \$879 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 14.4% for the six month period ended 30 June 2014 (30 June 2013: 0.7%) and its return on equity (profit for the period* as a percentage of total equity at the beginning of the period) was 1.5% for the six month period ended 30 June 2014 (six month period ended 30 June 2013: - 0.3%).

Balance Sheet Assets – Reducing the Group's total assets has been, and continues to be, a focus of the Group. The Group's total assets, as disclosed on page 16, decreased by 9% from \$519,566 million at 31 December 2013 to \$471,255 million at 30 June 2014.

Capital – The Group continues to closely manage its capital position in light of the implementation of Basel III during the period and leverage rules which are due to be phased in over future years. The Group's managed capital was \$23,735 million as at 30 June 2014 (31 December 2013: \$23,486 million) which consists of the Group's ordinary share capital, subordinated loans and reserves.

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 the six month period to 30 June 2014 was \$18 million compared with \$25 million for the six month period ended 30 June 2013 and was below internal risk management targets.

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.

* excludes the effect of the net currency translation loss on disposal of subsidiaries.

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Set out below is an overview of the Group's policies for the management of financial risk and other significant business risks. More detailed qualitative and quantitative disclosures about the Group's management of and exposure to financial risks are included in note 6 to the condensed consolidated financial statements. The nature of the principal risks that the Group is exposed to has not materially changed since the prior year and the Group does not anticipate a material change during the remaining six months of the financial year, although the Group continues to closely monitor and manage all of these principal risks, in particular in light of recent developments in Europe concerning Ukraine and Russia. The Group's exposure to Ukraine and Russia is limited. As at 30 June 2014 its net country risk exposure to Ukraine and Russia was \$13 million and \$279 million respectively. Details of the Group's five largest non-UK country risk net exposures and exposure to European peripherals at 30 June 2014 are included on pages 6 and 7.

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. During the six month period ended 30 June 2014, the average VaR for the Primary Risk Categories has declined from an average of \$20 million for the year ended 31 December 2013, to \$16 million in the six month period ended 30 June 2014. This has been driven by reduced exposure and lower implied and realised volatility for the main risk categories. The average Credit Portfolio VaR has decreased from \$8 million in the year ended 31 December 2013, to \$6 million in the six month period ended 30 June 2014, primarily due to reduced counterparty exposure during the period.

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.

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INTERIM MANAGEMENT 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.

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INTERIM MANAGEMENT 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⁾ \$millions	Net Counterparty Exposure ⁽²⁾ \$millions	Unfunded Commitments \$millions	Exposure Before Hedges \$millions	Hedges ⁽³⁾ \$millions	Net Exposure ⁽⁴⁾ \$millions
France:						
Sovereigns	(1,015)	-	-	(1,015)	(85)	(1,100)
Non-sovereigns	118	1,750	1,427	3,295	(130)	3,165
Total France	(897)	1,750	1,427	2,280	(215)	2,065
United States:						
Sovereigns	(888)	431	-	(457)	-	(457)
Non-sovereigns	(182)	1,716	-	1,534	(21)	1,513
Total United States	(1,070)	2,147	-	1,077	(21)	1,056
China:						
Sovereigns	236	53	-	289	-	289
Non-sovereigns	360	171	-	531	(8)	523
Total China	596	224	-	820	(8)	812
South Korea:						
Sovereigns	(63)	62	-	(1)	-	(1)
Non-sovereigns	130	547	-	677	(6)	671
Total South Korea	67	609	-	676	(6)	670
Netherlands:						
Sovereigns	(244)	2	-	(242)	(18)	(260)
Non-sovereigns	91	632	-	723	(23)	700
Total Netherlands	(153)	634	-	481	(41)	440

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

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

(3) Represents CDS hedges purchased 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 30 June 2014, the Group had exposure to these countries for overnight deposits with banks of approximately \$251 million.

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Country risk exposure (continued)

Country risk exposure to European Peripherals:

Country	Net Inventory ⁽¹⁾ \$millions	Net Counterparty Exposure ⁽²⁾ \$millions	Unfunded Commitments \$millions	CDS Adjustments ⁽³⁾ \$millions	Exposure Before Hedges \$millions	Hedges ⁽⁴⁾ \$millions	Net Exposure ⁽⁵⁾ \$millions
Greece:							
Sovereigns	47	-	-	-	47	-	47
Non-sovereigns	94	2	-	-	96	-	96
Total Greece	141	2	-	-	143	-	143
Ireland:							
Sovereigns	101	3	-	5	109	-	109
Non-sovereigns	336	33	-	2	371	-	371
Total Ireland	437	36	-	7	480	-	480
Italy:							
Sovereigns	(207)	271	-	159	223	(185)	38
Non-sovereigns	746	608	225	25	1,604	(93)	1,511
Total Italy	539	879	225	184	1,827	(278)	1,549
Spain:							
Sovereigns	423	10	-	6	439	-	439
Non-sovereigns	(28)	171	108	4	255	(48)	207
Total Spain	395	181	108	10	694	(48)	646
Portugal:							
Sovereigns	(73)	4	-	34	(35)	(17)	(52)
Non-sovereigns	151	10	-	26	187	-	187
Total Portugal	78	14	-	60	152	(17)	135
Total European Peripherals							
Sovereigns	291	288	-	204	783	(202)	581
Non-sovereigns	1,299	824	333	57	2,513	(141)	2,372
Total European Peripherals	1,590	1,112	333	261	3,296	(343)	2,953

- (1) Net inventory representing exposure to both long and short single name positions (i.e., bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).
- (2) Net counterparty exposure (i.e., repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.
- (3) CDS adjustments 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 on net counterparty exposure and funding 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 30 June 2014, the Group had European Peripherals exposure for overnight deposits with banks of approximately \$23 million.

MORGAN STANLEY & CO. INTERNATIONAL plc

INTERIM MANAGEMENT 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 6.

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 risk tolerance appetite set by the Board of Directors.

The Group's business is highly dependent on 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.

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INTERIM MANAGEMENT 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.

Legal and regulatory risk

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.

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.

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INTERIM MANAGEMENT REPORT

BUSINESS REVIEW (CONTINUED)

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 interim management report and Interim Financial Statements.

Approved by the Board and signed on its behalf by:



DAVID RUSSELL

Director

26 August 2014

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' RESPONSIBILITY STATEMENT

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

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

By order of the Board on 26 August 2014



DAVID RUSSELL

Director

Board of Directors:

C D S Bryce

D O Cannon

Sir E J W Gieve

T C Kelleher

(resigned as Chairman 1 January 2014)

F R Petitgas

M C Phibbs

I Plenderleith

(appointed as Chairman 1 January 2014)

R Rooney

D A Russell

L Bini Smaghi

(appointed 1 October 2013 and resigned 31 March 2014)

C E Woodman

INDEPENDENT REVIEW REPORT TO MORGAN STANLEY & CO. INTERNATIONAL plc

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six month period ended 30 June 2014 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated statement of changes in equity, the condensed consolidated statement of financial position, the condensed consolidated statement of cash flows and related notes 1 to 13. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

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

Directors' responsibilities

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

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

Our responsibility

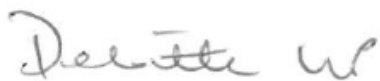
Our responsibility is to express to the Company a conclusion on the condensed set of interim financial statements in the half-yearly financial report based on our review.

Scope of review

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

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of interim financial statements in the half-yearly financial report for the six month period ended 30 June 2014 is not prepared, in all material aspects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.



Deloitte LLP
Chartered Accountants and Statutory Auditor
London
26 August 2014

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED INCOME STATEMENT

Six months ended 30 June 2014

		Six months ended 30 June 2014 \$millions (unaudited)	Restated Six months ended 30 June 2013 \$millions (unaudited)
	Note		
Net gains on financial instruments classified as held for trading		2,201	1,953
Net gains on financial instruments designated at fair value through profit or loss		147	21
Interest income		220	572
Interest expense		(355)	(745)
Other income		299	249
Other expense		(2,150)	(2,035)
Net currency translation loss on disposal of subsidiaries	11	-	(151)
PROFIT/ (LOSS) BEFORE TAX		<u>362</u>	<u>(136)</u>
Income tax expense	2	(128)	(56)
PROFIT/(LOSS) FOR THE PERIOD		<u><u>234</u></u>	<u><u>(192)</u></u>
Attributable to:			
Owners of the parent		233	(193)
Non-controlling interests		1	1
PROFIT/ (LOSS) FOR THE PERIOD		<u><u>234</u></u>	<u><u>(192)</u></u>

All operations were continuing in the current and prior periods.

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

Details of the restatement are provided in note 1.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Six months ended 30 June 2014

	Six months ended 30 June 2014 \$millions (unaudited)	Six months ended 30 June 2013 \$millions (unaudited)
PROFIT/ (LOSS) FOR THE PERIOD	<u>234</u>	<u>(192)</u>
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Items that will not be reclassified subsequently to profit or loss:		
Actuarial losses on defined benefit plans	-	(1)
Items that may be reclassified subsequently to profit or loss:		
Currency translation reserve:		
Foreign currency translation differences arising on foreign operations during the period	15	(16)
Net loss reclassified to condensed consolidated income statement	-	151
Available-for-sale reserve:		
Net change in fair value of available-for-sale financial assets	1	1
OTHER COMPREHENSIVE INCOME AFTER INCOME TAX	<u>16</u>	<u>135</u>
TOTAL COMPREHENSIVE INCOME/ (LOSS)	<u>250</u>	<u>(57)</u>
Attributable to:		
Owners of the parent	249	(57)
Non-controlling interests	1	-
TOTAL COMPREHENSIVE INCOME/ (LOSS)	<u>250</u>	<u>(57)</u>

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY Six months ended 30 June 2014

	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 2014	11,464	513	78	4	3	1,400	2,118	15,580	79	15,659
Total comprehensive income	-	-	15	1	-	-	233	249	1	250
Balance at 30 June 2014 (unaudited)	11,464	513	93	5	3	1,400	2,351	15,829	80	15,909

	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 2013	9,464	513	(105)	4	3	1,400	2,172	13,451	74	13,525
Total comprehensive loss	-	-	(15)	1	-	-	(194)	(208)	-	(208)
Reclassified foreign currency translation differences on liquidation of foreign subsidiaries	-	-	151	-	-	-	-	151	-	151
Balance at 30 June 2013 (unaudited)	9,464	513	31	5	3	1,400	1,978	13,394	74	13,468

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION
As at 30 June 2014

		30 June 2014	31 December 2013
		\$millions	\$millions
ASSETS	Note	(unaudited)	
Loans and receivables:			
Cash and short term deposits	4	11,751	12,244
Cash collateral on securities borrowed		16,685	17,372
Securities purchased under agreements to resell		76,542	75,717
Trade receivables		91,840	72,220
Other receivables		2,529	2,965
		<u>199,347</u>	<u>180,518</u>
Financial assets classified as held for trading (of which approximately \$44,019 million (2013: \$45,178 million) were pledged to various parties)	3	265,480	330,923
Financial assets designated at fair value through profit or loss		5,985	7,673
Available-for-sale financial assets		61	60
Current tax assets		213	229
Deferred tax assets		101	115
Prepayments and accrued income		64	43
Property, plant and equipment		4	5
TOTAL ASSETS		<u><u>471,255</u></u>	<u><u>519,566</u></u>
LIABILITIES AND EQUITY			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	4	75	16
Cash collateral on securities loaned		17,119	13,457
Securities sold under agreements to repurchase		56,729	70,016
Trade payables		118,179	97,946
Subordinated loans		7,906	7,906
Other payables		11,848	18,179
		<u>211,856</u>	<u>207,520</u>
Financial liabilities classified as held for trading	3	230,379	282,764
Financial liabilities designated at fair value through profit or loss		12,563	13,123
Provisions		29	30
Current tax liabilities		250	242
Deferred tax liabilities		3	3
Accruals and deferred income		262	221
Post employment benefit obligations		4	4
TOTAL LIABILITIES		<u><u>455,346</u></u>	<u><u>503,907</u></u>
EQUITY			
Share capital		11,464	11,464
Share premium account		513	513
Currency translation reserve		93	78
Available-for-sale-reserve		5	4
Capital contribution reserve		3	3
Capital redemption reserve		1,400	1,400
Retained earnings		2,351	2,118
Equity attributable to owners of the parent		<u>15,829</u>	<u>15,580</u>
Non-controlling interests		<u>80</u>	<u>79</u>
TOTAL EQUITY		<u><u>15,909</u></u>	<u><u>15,659</u></u>
TOTAL LIABILITIES AND EQUITY		<u><u>471,255</u></u>	<u><u>519,566</u></u>

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

As at 30 June 2014

		Six months ended 30 June 2014 \$millions (unaudited)	Six months ended 30 June 2013 \$millions (unaudited)
	Note		
NET CASH FLOWS USED IN OPERATING ACTIVITIES	4(b)	(479)	(538)
INVESTING ACTIVITIES			
Purchase of available-for-sale financial assets		-	(6)
Proceeds from sale of available-for-sale financial assets		1	6
Proceeds from sale of subsidiaries, net of cash		-	1,835
NET CASH FLOWS FROM INVESTING ACTIVITIES		<u>1</u>	<u>1,835</u>
FINANCING ACTIVITIES			
Interest on subordinated loan liabilities		(68)	(61)
NET CASH FLOWS USED IN FINANCING ACTIVITIES		<u>(68)</u>	<u>(61)</u>
NET (DECREASE)/ INCREASE IN CASH AND CASH EQUIVALENTS		(546)	1,236
Currency translation differences on foreign currency cash balances		(6)	(141)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD		<u>12,228</u>	<u>11,503</u>
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	4(a)	<u><u>11,676</u></u>	<u><u>12,598</u></u>

The notes on pages 18 to 71 form an integral part of the Interim Financial Statements.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

1. BASIS OF PREPARATION

a. General information

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

The comparative information for the year ended 31 December 2013 does not constitute statutory accounts as defined in section 434 of the Companies Act. A copy of the statutory accounts for that year has been delivered to the Registrar of Companies. The auditor's report on those accounts was not qualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying the report and did not contain statements under section 498(2) or (3) of the Companies Act.

b. Accounting policies

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

In preparing these Interim Financial Statements the Group has applied consistently the accounting policies and methods of computation used in the Group's annual consolidated financial statements for the year ended 31 December 2013, except where noted below.

New standards and interpretations adopted during the period

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

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

Amendments to IFRS 10 '*Consolidated financial statements*', IFRS 12 '*Disclosure of interests in other entities*' and IAS 27 '*Consolidated and separate financial statements*' ("IAS 27") 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 and was endorsed by the EU in June 2014.

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

New standards and interpretations not yet adopted

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

Amendments to IAS 16 '*Property, plant and equipment*' ("IAS 16") and IAS 38 '*Intangible assets*' ("IAS 38") were issued by the IASB in May 2014, for prospective application in annual periods beginning on or after 1 January 2016.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

1. BASIS OF PREPARATION(CONTINUED)

New standards and interpretations not yet adopted (continued)

An amendment to IAS 19 '*Employee benefits on defined benefit plans*' 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, amended in November 2013, and revised and reissued by the IASB in July 2014. Retrospective application is required by IFRS 9, which is effective for annual periods beginning on or after 1 January 2018. Early adoption, either in full or relating to own credit in isolation, is permitted. 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.

An amendment to IFRS 11 '*Joint arrangements*' was issued by the IASB in May 2014, for prospective application in annual periods beginning on or after 1 January 2016.

IFRS 15 '*Revenue from Contracts with Customers*' was issued by the IASB in May 2014 for retrospective application in annual periods beginning on or after 1 January 2017.

An amendment to IAS 27 was issued by the IASB in August 2014, for retrospective application for annual periods beginning on or after 1 January 2016. Early adoption is permitted.

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 3 '*Business combinations*', IFRS 8 '*Operating segments*', IFRS 13 '*Fair value measurement*', IAS 16, IAS 24 '*Related party disclosures*' and IAS 38 (for application in accounting periods beginning on or after 1 July 2014).

c. Use of estimates and sources of uncertainty

The preparation of the Group's condensed 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 Interim Financial Statements and related disclosures. The Group believes that the estimates utilised in preparing these Interim Financial Statements are reasonable, relevant and reliable. Actual results could differ from these estimates.

For further details on the judgements used in determining whether the Group should consolidate a structured entity and in determining fair value of certain assets and liabilities see note 8 and note 9 respectively.

d. Restatement of comparative amounts

The condensed consolidated income statement includes the following prior year classification adjustments:

- i) Interest income and interest expense were both reduced by \$1,160 million. This relates to interest income and expense that was incorrectly presented gross. This error had no impact on the Group's profit within the Group's condensed consolidated income statement or the condensed consolidated statement of financial position for the period. Cash flows in note 4 have been revised as a result of the restatement.
- ii) Net income from financial instruments held for trading was reduced by \$587 million and net income from financial instruments designated at fair value increased by \$587 million. This relates to trades being incorrectly classified within financial instruments designated at fair value which should have been classified as financial instruments held for trading. This error had no impact on the Group's profit within the Group's condensed consolidated income statement or the condensed consolidated statement of financial position for the period. Note 5 has been revised as a result of the restatement.

Certain other limited format changes have been made to prior period amounts to conform to the current period presentation.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

2. INCOME TAX EXPENSE

The Group's tax expense has been accrued based on the expected tax rate that takes into account current expectations concerning the allocation of group relief within the Morgan Stanley UK tax group and prevailing tax rates in the jurisdictions in which the Group operates.

The Group's effective tax rate for the six month period ended 30 June 2014 is 35.4%, which is higher than that resulting from applying the average standard rate of corporation tax in the UK of 21.49%. The main reason for the higher effective tax rate is attributed to expenses relating to prior years which have been reflected in prior year's tax returns. The reduction in prior year's taxable income resulted in a reduction in double tax relief.

The Group's effective tax rate for the six month period ended 30 June 2013 was 41.2%, which is higher than that resulting from applying the average standard rate of corporation tax in the UK of 23.25%. The main reason for the higher effective tax rate is attributed to the loss on disposal of subsidiaries that is non-tax deductible, and the impact of transferring taxable losses outside of the Group.

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

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

	30 June 2014	30 June 2014	31 December 2013	31 December 2013
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
Fair value				
Government debt securities	14,036	14,930	9,703	8,805
Corporate and other debt	12,161	2,437	11,747	2,691
Corporate equities	40,429	18,404	44,680	17,833
Derivatives	198,854	194,608	264,793	253,435
	<u>265,480</u>	<u>230,379</u>	<u>330,923</u>	<u>282,764</u>

4. ADDITIONAL CASH FLOW INFORMATION

a. Cash and cash equivalents

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

	30 June 2014	30 June 2013
	\$millions	\$millions
Cash and short-term deposits	11,751	12,613
Bank loans and overdrafts	(75)	(15)
	<u>11,676</u>	<u>12,598</u>

Included within 'Cash and short-term deposits' is \$8,719 million (30 June 2013: \$8,030 million) of segregated client funds that are not available for use by the Group. The corresponding payable is recognised and included in 'Trade payables' within 'Financial liabilities at amortised cost'.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

4. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)

b. Reconciliation of cash flows from operating activities

	Six months ended 30 June 2014 \$millions	Six months ended 30 June 2013 \$millions
Profit/ (loss) for the period	234	(192)
Adjustments for:		
Depreciation on property, plant and equipment	2	2
Interest income (restated) ⁽¹⁾	(220)	(572)
Interest expense (restated) ⁽¹⁾	355	745
Loss on disposal of subsidiaries	-	151
Income tax expense	128	56
Other expense	-	1
Operating cash flows before changes in operating assets and liabilities	<u>499</u>	<u>191</u>
Change in operating assets		
Increase in loans and receivables, excluding cash and short term deposits	(19,061)	(46,370)
Decrease/ (increase) in financial assets classified as held for trading	65,443	(2,576)
Decrease/ (increase) in financial assets designated at fair value through profit or loss	<u>1,688</u>	<u>(158)</u>
	<u>48,070</u>	<u>(49,104)</u>
Change in operating liabilities		
Increase in financial liabilities at amortised cost, excluding bank loans and overdrafts	3,826	40,948
(Decrease)/ increase in financial liabilities classified as held for trading	(52,385)	7,259
(Decrease)/ increase in financial liabilities designated at fair value through profit or loss	(560)	237
Decrease in provisions	<u>(1)</u>	<u>(76)</u>
	<u>(49,120)</u>	<u>48,368</u>
Interest received (restated)*	(62)	138
Interest paid (restated)*	207	(155)
Income taxes paid	(91)	(97)
Effect of foreign exchange movements	18	121
Net cash flows used in operating activities	<u><u>(479)</u></u>	<u><u>(538)</u></u>

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

5. 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, Institutional Securities and Investment Management. Institutional Securities includes the following activities: financial advisory services 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 consolidated information is presented below.

Condensed consolidated income statement information Six months ended 30 June 2014	Institutional Securities \$millions	Investment Management \$millions	Total \$millions
Net gains on financial instruments classified as held for trading	2,193	8	2,201
Net losses on financial instruments designated at fair value through profit or loss	147	-	147
Net interest expense	(134)	(1)	(135)
Other income	292	7	299
External revenues net of interest	2,498	14	2,512
Other expense	(2,117)	(33)	(2,150)
Profit/ (loss) before tax	381	(19)	362
Income tax (expense)/ credit	(132)	4	(128)
Profit/ (loss) for the period	249	(15)	234

Condensed consolidated statement of financial position information As at 30 June 2014	Institutional Securities \$millions	Investment Management \$millions	Total \$millions
Segment assets	471,255	-	471,255
Segment liabilities	455,346	-	455,346
Other segment information			
Depreciation and amortisation	2	-	2

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

5. SEGMENT REPORTING (CONTINUED)

Business segments (continued)

Condensed consolidated income statement information	Institutional Securities \$millions	Investment Management \$millions	Total \$millions
Six months ended 30 June 2013			
Net gains on financial instruments classified as held for trading (restated) ⁽¹⁾	1,953	-	1,953
Net gains on financial instruments designated at fair value through profit or loss (restated) ⁽¹⁾	21	-	21
Loss on disposal of subsidiaries	(151)	-	(151)
Net interest expense	(173)	-	(173)
Other income	234	15	249
External revenues	1,884	15	1,899
Other expense	(2,007)	(28)	(2,035)
Loss before tax	(123)	(13)	(136)
Income tax (expense)/ credit	(59)	3	(56)
Loss for the period	(182)	(10)	(192)

Condensed consolidated statement of financial position information	Institutional Securities \$millions	Investment Management \$millions	Total \$millions
As at 31 December 2013			
Segment assets	519,559	7	519,566
Total assets	519,559	7	519,566
Segment liabilities	503,900	7	503,907
Total liabilities	503,900	7	503,907

Other segment information

Depreciation on property, plant and equipment	2	-	2
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⁽¹⁾ Details of the restatement are provided in note 1.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

5. SEGMENT REPORTING (CONTINUED)

Geographical segments

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

The following table presents selected condensed consolidated income statement and condensed 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.

Geographical Segments	EMEA		Americas		Asia		Total	
	30 June	30 June	30 June	30 June	30 June	30 June	30 June	30 June
	2014	2013	2014	2013	2014	2013	2014	2013
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
External revenues net of interest	2,410	1,790	40	21	62	88	2,512	1,899
Profit before income tax	332	(122)	8	(31)	22	17	362	(136)
	30 June	31 Dec	30 June	31 Dec	30 June	31 Dec	30 June	31 Dec
	2014	2013	2014	2013	2014	2013	2014	2013
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Total assets	367,908	415,084	59,897	51,586	43,450	52,896	471,255	519,566

6. 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

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.

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 30 June 2014, 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 30 June 2014, 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 condensed consolidated statement of financial position.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Collateral and other credit enhancements (continued)

- *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.

Exposure to credit risk

The maximum exposure to credit risk ("gross credit exposure") of the Group as at 30 June 2014 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 condensed 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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class

	30 June 2014			31 December 2013		
Class	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	11,751	-	11,751	12,244	-	12,244
Cash collateral on securities borrowed	16,685	(16,254)	431	17,372	(16,810)	562
Securities purchased under agreements to resell	76,542	(73,834)	2,708	75,717	(73,030)	2,687
Trade receivables ⁽³⁾	54,658	-	54,658	47,848	-	47,848
Other receivables	2,529	-	2,529	2,336	-	2,336
Financial assets classified as held for trading:						
Derivatives	198,854	(187,988)	10,866	264,793	(252,050)	12,743
Financial assets designated at fair value through profit or loss	5,985	(5,714)	271	7,673	(5,643)	2,030
	367,004	(283,790)	83,214	427,983	(347,533)	80,450
Unrecognised financial instruments						
Contingent commitments	859	-	859	821	-	821
Letters of credit	1	-	1	1	-	1
Loan commitments	1,790	-	1,790	1,870	-	1,870
Underwriting commitments	872	-	872	588	-	588
Unsettled securities purchased under agreements to resell ⁽⁴⁾	38,969	-	38,969	23,857	-	23,857
	409,495	(283,790)	125,705	455,120	(347,533)	107,587

(1) The carrying amount recognised in the condensed 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 \$3,136 million (2013: \$2,977 million) to be offset in the event of default by certain Morgan Stanley counterparties.

(3) Trade receivables 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 condensed 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.

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 7.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Maximum exposure to credit risk by credit rating ⁽¹⁾

Credit ratings:	Gross credit exposure	
	30 June 2014 \$millions	31 December 2013 \$millions
AAA	16,255	12,572
AA	104,371	97,249
A	207,564	259,253
BBB	54,541	52,084
BB	16,029	17,344
B	5,065	7,113
CCC	2,200	3,889
D	131	-
Unrated	3,339	5,616
Total	409,495	455,120

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

At 30 June 2014 there were no financial assets past due but not impaired or individually impaired (31 December 2013: \$nil).

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 fulfil 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").

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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

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 30 June 2014, 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 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

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Liquidity Reserve (continued)

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 programme 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.

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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

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 30 June 2014 and 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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Maturity analysis (continued)

	On demand	Less than 1 month	Equal to or more than 1 month but less than 3 months	Equal to or more than 3 months but less than 1 year	Equal to or more than 1 year but less than 5 years	Equal to or more than 5 years	Total
30 June 2014	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	75	-	-	-	-	-	75
Cash collateral on securities loaned	15,544	175	137	1,263	-	-	17,119
Securities sold under agreements to repurchase	18,425	14,124	7,931	13,560	2,753	41	56,834
Trade payables	118,179	-	-	-	-	-	118,179
Subordinated loans	-	-	-	138	969	10,502	11,609
Other payables	4,255	2	6	4,233	116	4,066	12,678
Financial liabilities classified as held for trading:							
Derivatives	194,608	-	-	-	-	-	194,608
Other	35,771	-	-	-	-	-	35,771
Financial liabilities designated at fair value through profit or loss	9,714	8	52	860	1,453	476	12,563
Total financial liabilities	396,571	14,309	8,126	20,054	5,291	15,085	459,436
Unrecognised financial instruments							
Contingent commitments	859	-	-	-	-	-	859
Lease commitments	-	1	2	5	20	7	35
Letters of credit	1	-	-	-	-	-	1
Loan commitments	1,790	-	-	-	-	-	1,790
Underwriting commitments	-	256	518	98	-	-	872
Unsettled securities purchased under agreements to resell ⁽¹⁾	37,832	456	681	-	-	-	38,969
Total unrecognised financial instruments	40,482	713	1,201	103	20	7	42,526

(1) The Group enters into forward starting unsettled securities purchased under agreements to resell (agreements which have a trade date at or prior to 30 June 2014 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 30 June 2014, \$37,832 million settled within three business days.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Maturity analysis (continued)

31 December 2013	On demand \$millions	Less than 1 month \$millions	Equal to or more than 1 month but less than 3 months \$millions	Equal to or more than 3 months but less than 1 year \$millions	Equal to or more than 1 year but less than 5 years \$millions	Equal to or more than 5 years \$millions	Total \$millions
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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Six months ended 30 June 2014

6. 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.

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.

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Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Primary market risk exposures and market risk management (continued)

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.

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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR methodology, assumptions and limitations (continued)

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 six month period ended 30 June 2014

The table below presents the Management VaR for the Group's Trading portfolio, on a period-end, period average and period high and low basis for 30 June 2014 and 31 December 2013.

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.

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% VaR	95%/ one-day VaR for the six months ended 30 June 2014				95%/ one-day VaR for the year ended 31 December 2013			
Market Risk Category	Period				Period			
	End	Average	High	Low	End	Average	High	Low
	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million
Interest rate and credit spread	11	12	16	9	15	13	24	9
Equity price	12	12	15	11	14	14	32	11
Foreign exchange rate	2	3	6	2	5	4	8	2
Commodity price	1	1	2	1	1	1	2	1
Less: Diversification benefit ⁽¹⁾⁽²⁾	(9)	(12)	N/A	N/A	(15)	(12)	N/A	N/A
Primary Risk Categories VaR	17	16	21	14	20	20	37	15
Credit Portfolio VaR	5	6	8	4	6	8	12	6
Less: Diversification benefit ⁽¹⁾⁽²⁾	(3)	(4)	N/A	N/A	(4)	(6)	N/A	N/A
Total Management VaR	19	18	23	16	22	22	41	17

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

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

The Group's average Management VaR for Primary Risk Categories for the six month period ended 30 June 2014 was \$16 million compared with \$20 million for the year ended 31 December 2013. The decrease in the average VaR for Primary Risk Categories is primarily due to reduced exposure and lower implied and realised volatility for the main risk categories.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Sensitivity analysis (continued)

The average Credit Portfolio VaR for the six month period ended 30 June 2014 was \$6 million compared with \$8 million for the year ended 31 December 2013. The decrease in the average VaR over the period was from decreased counterparty exposure.

The average total Management VaR for the six month period ended 30 June 2014 was \$18 million compared with \$22 million for the year ended 31 December 2013.

Non-trading risks for the six month period ended 30 June 2014

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

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net gain or loss of approximately \$4.3 million as at 30 June 2014, compared to a net gain or loss of approximately \$3.8 million as at 31 December 2013.

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 \$2.9 million and \$2.7 million for each 1 basis point widening in the Group's credit for both 30 June 2014 and 31 December 2013, 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 \$0.4 million and \$0.5 million for each 1 basis point widening in the Group's credit spread level for both 30 June 2014 and 31 December 2013, 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.

	30 June 2014	31 December 2013
	10% sensitivity	10% sensitivity
	\$millions	\$millions
Available-for-sale financial assets	<u>6</u>	<u>6</u>

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk

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

The analysis below details the foreign currency exposure for the Group, by foreign currency, 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.

	30 June 2014			31 December 2013		
	Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)		
	Foreign currency exposure \$millions	Percentage change applied %	Other comprehensive income \$millions	Foreign currency exposure \$millions	Percentage change applied %	Other comprehensive income \$millions
Australian Dollar	(54)	27%	(15)	(40)	27%	(11)
British Pound	60	11%	7	57	11%	6
Euro	511	7%	36	479	7%	34
New Taiwan Dollar	71	8%	6	65	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Polish Zloty	3	16%	-	4	16%	1
South Korean Won	205	12%	25	203	12%	24
Swedish Krona	16	9%	1	17	9%	2
Swiss Franc	12	10%	1	11	10%	1
	<u>826</u>		<u>61</u>	<u>798</u>		<u>62</u>

The reasonably possible percentage change in the currency rate in relation to the US dollars has been calculated based on the greatest annual percentage change over the period from 1 January 2009 to 30 June 2014. Thus, the percentage change applied may not be the same percentage as the actual change in the currency rate for the six month period ended 30 June 2014, or for the year ended 31 December 2013.

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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

7. 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 6 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 condensed 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 6.

The amounts offset in the condensed consolidated statement of financial position against both financial assets and liabilities classified as held for trading – derivatives was \$88,566 million as at 30 June 2014 compared to \$20,953 million as at 31 December 2013. The reason for the increase is due to additional counterparty netting following revision to settlement procedures and restructuring of trades.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

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

	Gross amounts ⁽¹⁾	Amounts offset in the condensed consolidated statement of financial position ⁽²⁾	Net amounts presented in the condensed consolidated statement of financial position	Amounts not offset in the condensed consolidated statement of financial position ^{(3) (4) (5) (6)}		Net exposure ⁽⁷⁾
	\$millions	\$millions	\$millions	Financial instruments	Cash collateral	\$millions
30 June 2014						
Assets						
Loans and receivables:						
Cash collateral on securities borrowed	31,455	(14,770)	16,685	(16,254)	-	431
Securities purchased under agreements to resell	92,728	(16,186)	76,542	(73,834)	-	2,708
Financial assets classified as held for trading:						
Derivatives	287,420	(88,566)	198,854	(159,283)	(28,705)	10,866
TOTAL	411,603	(119,522)	292,081	(249,371)	(28,705)	14,005
Liabilities						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned	31,889	(14,770)	17,119	(16,984)	-	135
Securities sold under agreements to repurchase	72,915	(16,186)	56,729	(49,719)	-	7,010
Financial liabilities classified as held for trading:						
Derivatives	283,174	(88,566)	194,608	(158,620)	(20,672)	15,316
TOTAL	387,978	(119,522)	268,456	(225,323)	(20,672)	22,461

- (1) Amounts include \$220 million of cash collateral on securities borrowed, \$1,565 million of securities purchased under agreements to resell, \$5,075 million of financial assets classified as held for trading – derivatives, \$27 million of cash collateral on securities loaned, \$6,320 million of securities sold under agreements to repurchase and \$5,030 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 condensed 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. Certain trade receivables and payables have legally enforceable master netting arrangements in place and are eligible for netting such that \$7,566 million is presented net within the condensed consolidated statement of financial position.
- (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 condensed consolidated statement of financial position.
- (4) The cash collateral is recognised in the condensed consolidated statement of financial position within trade receivables and payables respectively.
- (5) Certain trade receivables and payables of \$9,787 million not presented net in the condensed 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.
- (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 condensed consolidated statement of financial position. \$4 million not presented net in the condensed 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 \$3,136 million (Dec 2013: \$2,977 million) to be offset in the ordinary course of business and/ or in the event of default.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

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

	Gross amounts ⁽¹⁾	Amounts offset in the condensed consolidated statement of financial position ⁽²⁾	Net amounts presented in the condensed consolidated statement of financial position	Amounts not offset in the condensed consolidated statement of financial position ^{(3) (4) (5) (6)}		
	\$millions	\$millions	\$millions	Financial instruments \$millions	Cash collateral \$millions	Net exposure ⁽⁷⁾ \$millions
31 December 2013						
Assets						
Loans and receivables:						
Cash collateral on securities borrowed	33,116	(15,744)	17,372	(16,810)	-	562
Securities purchased under agreements 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 agreements 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 condensed 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 condensed consolidated statement of financial position.
- (4) The cash collateral is recognised in the condensed consolidated statement of financial position within trade receivables and payables respectively.
- (5) Certain trade receivables and payables that are not presented net within the condensed 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 condensed consolidated statement of financial position. \$15 million not presented net in the condensed 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

8. 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; and
- 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.

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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

8. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

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 condensed 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 condensed 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.

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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

8. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Consolidated structured entities

As at 30 June 2014, the Group did not have any structured entities that it consolidated. The table below shows information about the structured entities the Group consolidated as at 31 December 2013. Consolidated structured entity assets and liabilities are presented after intercompany eliminations and include assets financed on a non-recourse basis:

	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

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 Interim 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 at 31 December 2013. 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), 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.

The tables below show certain non-consolidated structured entities in which the Group had an interest at 30 June 2014 and 31 December 2013. 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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

8. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligation \$millions	Fund investments \$millions	Other \$millions	Total \$millions
30 June 2014					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	26,725	2,898	4,324	144	34,091
Maximum exposure to loss:					
Debt and equity interests	913	128	-	12	1,053
Derivative and other contracts	-	-	4,324	42	4,366
Total maximum exposure to loss	913	128	4,324	54	5,419
Carrying value of exposure to loss - assets:					
Debt and equity interests ⁽¹⁾	913	128	-	12	1,053
Total carrying value of exposure to loss - assets	913	128	-	12	1,053
Carrying value of exposure to loss - liabilities:					
Derivatives and other contracts ⁽¹⁾	-	-	30	2	32
Total carrying value of exposure to loss - liabilities	-	-	30	2	32

(1) Amounts are recognised in the condensed 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 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

8. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligation \$millions	Fund investments \$millions	Other \$millions	Total \$millions
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:					
Derivatives and other contracts ⁽¹⁾	-	-	6	1	7
Total carrying value of exposure to loss - liabilities	-	-	6	1	7

(1) Amounts are recognised in the condensed 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

8. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

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 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.

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 \$552 million at 30 June 2014 (31 December 2013: \$542 million). These securities were retained in connection with transfers of assets by the Group. Securities issued by securitisation structured entities consist of \$278 million of securities backed primarily by residential mortgage loans (31 December 2013: \$244 million), \$59 million of securities backed by commercial mortgage loans (31 December 2013: \$160 million), \$154 million of securities backed by collateralised debt obligations or collateralised loan obligations (31 December 2013: \$137 million) and \$60 million backed by other consumer loans (31 December 2013: \$1 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 30 June 2014, 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 the six month period to 30 June 2014 was \$4 million. Losses and gains are reported under 'Net gains on financial instruments classified as held for trading' in the condensed consolidated income statement. No assets were transferred to the sponsored unconsolidated structured entities during the six month period to 30 June 2014 (2013: \$nil).

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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.

30 June 2014

	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant non- observable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
- Government debt securities	10,748	3,278	10	14,036
- Corporate and other debt	-	11,687	474	12,161
- Corporate equities	36,627	3,706	96	40,429
- Derivatives	492	194,247	4,115	198,854
Total financial assets classified as held for trading	47,867	212,918	4,695	265,480
Financial assets designated at fair value through profit or loss	-	4,437	1,548	5,985
Available-for-sale financial assets:				
- Corporate equities	3	-	58	61
Total financial assets measured at fair value	47,870	217,355	6,301	271,526
Financial liabilities classified as held for trading:				
- Government debt securities	12,740	2,190	-	14,930
- Corporate and other debt	-	2,431	6	2,437
- Corporate equities	17,707	688	9	18,404
- Derivatives	947	189,047	4,614	194,608
Total financial liabilities classified as held for trading	31,394	194,356	4,629	230,379
Financial liabilities designated at fair value through profit or loss	-	12,460	103	12,563
Total financial liabilities measured at fair value	31,394	206,816	4,732	242,942

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

31 December 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

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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.

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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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)*

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.

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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

- *Customer Loans(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.

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 six month period ended 30 June 2014 and for the year ended 31 December 2013.

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

The following table presents the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the six months ended 30 June 2014 and 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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

30 June 2014

	Balance at 1 January 2014 \$million	Total gains or (losses) recognised in condensed consolidated income statement \$million	Total gains or (losses) recognised in condensed consolidated other comprehensive income \$million	Purchases \$million	Sales \$million	Issuances \$million	Settlements \$million	Net transfers in and/or out of Level 3 ⁽¹⁾ \$million	Balance at 30 June 2014 \$million	Unrealised gains or (losses) for level 3 assets/ liabilities outstanding as at 30 June 2014 ⁽²⁾ \$million
Financial assets classified as held for trading:										
- Government debt securities	23	-	-	8	(20)	-	-	(1)	10	-
- Corporate and other debt	714	31	-	176	(341)	-	(183)	77	474	26
- Corporate equities	69	19	-	36	(42)	-	-	14	96	13
Total financial assets classified as held for trading	806	50	-	220	(403)	-	(183)	90	580	39
Financial assets designated at fair value through profit or loss	1,598	(187)	-	180	-	-	(181)	138	1,548	(197)
Available-for-sale financial assets:										
- Corporate equities	58	-	-	-	-	-	-	-	58	-
Total financial assets measured at fair value	2,462	(137)	-	400	(403)	-	(364)	228	2,186	(158)
Financial liabilities classified as held for trading:										
- Corporate and other debt	47	(2)	-	(8)	3	-	-	(38)	6	-
- Corporate equities	8	-	-	(6)	-	-	-	7	9	-
- Net derivative contracts ⁽³⁾	530	(488)	-	(1,334)	-	911	(152)	56	499	(162)
Total financial liabilities classified as held for trading	585	(490)	-	(1,348)	3	911	(152)	25	514	(162)
Financial liabilities designated at fair value through profit or loss	257	2	-	-	-	80	(240)	8	103	2
Total financial liabilities measured at fair value	842	(488)	-	(1,348)	3	991	(392)	33	617	(160)

- (1) For financial assets and financial liabilities that were transferred into and out of Level 3 during the period, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the period.
- (2) Amounts represent unrealised gains or (losses) for the period related to assets and liabilities still outstanding as at the end of the period. The unrealised gains or (losses) are recognised in the condensed consolidated income statement or condensed consolidated statement of comprehensive income as detailed in the financial instruments accounting policy in the Group's annual consolidated financial statements for the year ended 31 December 2013.
- (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 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

31 December 2013

	Balance at 1 January 2013	Total gains or (losses) recognised in consolidated income statement	Total gains or (losses) recognised in consolidated other comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and/or out of Level 3 ⁽¹⁾	Balance at 31 December 2013	Unrealised gains or (losses) for level 3 assets/ liabilities outstanding as at 31 December 2013 ⁽²⁾
	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million	\$million
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 period, gains or (losses) are presented as if the assets or liabilities had been transferred into or out of Level 3 as at the beginning of the period.

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

(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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

During the period, there were no material transfers between Levels 2 and 3 (2013: \$nil) of the fair value hierarchy.

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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. 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)

30 June 2014

	Fair value	Valuation technique	Significant unobservable input(s) / Sensitivity of the fair value to changes in the unobservable inputs	Range ⁽²⁾	Averages ⁽³⁾
ASSETS	\$millions				
Financial assets classified as held for trading:					
- Corporate equities	96	Comparable pricing	Comparable equity price / (A)	100%	100%
		Market Approach	EBITDA Multiple / (A)	8 to 11 times	10 times
- Corporate and other debt:					
- Residential mortgage backed securities	25	Comparable pricing	Comparable bond price / (A)	5 to 6 points	6 points
- Commercial mortgage backed securities	49	Comparable pricing	Comparable bond price / (A)	4 to 6 points	4 points
- Asset backed securities	130	Comparable pricing	Comparable bond price / (A)	49 to 100 points	92%
		Comparable pricing	Comparable bond price / (A)	4 to 100 points	40 points
- Corporate bonds	160	Comparable pricing	Comparable bond price / (A)	10 to 105 points	88 points
		Option Model	At the money volatility / (A)	5% to 63%	28%
		Option Model	Volatility skew / (A)	-2% to 1%	0%
		Comparable pricing	Comparable bond price / (A)	5 to 65 points	40 points
- Collateralised debt obligations	86	Comparable pricing	Comparable loan price / (A)	30 to 100 points	87 points
		Correlation Model	Credit Correlation / (B)	54% to 80%	57%
Available for sale financial assets:					
- Corporate equities	58	Comparable pricing	Comparable equity price / (A)	100%	100%
Financial assets designated at fair value through profit or loss:					
- Customer loans	1,528	Margin Loan Model	Credit spread / (C)(D)	199 bps	199bps
		Margin Loan Model	Volatility skew / (C)(D)	4% to 42%	26%
		Margin Loan Model	Comparable price / (A)(D)	80% to 120%	100%
		Option Model	Volatility skew / (C)	-1% to 0%	-1%

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/ (decreases) 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. 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)

30 June 2014

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:					
- Net derivative contracts: ⁽¹⁾					
- Credit	5	Correlation Model	Credit correlation / (B)	16% to 85%	56%
		Comparable pricing	Comparable bond price / (C)(D)	3 to 99 points	37 points
		Comparable pricing	Cash Synthetic Basis / (C)(D)	3 to 12 points	10 points
- Equity ⁽⁵⁾	(749)	Option Model	At the money volatility / (C)(D)	7% to 57%	28%
		Option Model	Volatility skew / (C)(D)	-4% to 0%	-1%
		Option Model	Equity correlation / (C)(D)	30% to 99%	65%
		Option Model	Equity Foreign exchange correlation / (C)(D)	-30% to 10%	-17%
- Interest rate ⁽⁴⁾	7	Option Model	Comparable bond price / (A)(D)	2 to 13 points	9, 10 points
		Option Model	Inflation volatility / (A)(D)	79% to 79%	79%, 79%
		Option Model	Interest rate / (A)(D)	0% to 1%	0.5%, 0%
		Option Model	Interest rate - Foreign exchange correlation / (A)(D)	47% to 48%	48%, 48%
		Option Model	Interest rate – Inflation correlation / (A)(D)	-39% to -42%	-41%, -41%
		Option Model	Interest rate curve correlation / (A)(D)	36% to 94%	71%, 76%
		Option Model	Interest rate quanto correlation / (A)(D)	-11% to 37%	6%, -8%
		Option Model	Interest rate volatility skew / (A)(D)	25% to 59%	39%, 29%
- Foreign exchange ⁽⁴⁾⁽⁵⁾	241	Option Model	Interest rate / (A)(D)	0% to 1%	0.5%, 0%
		Option Model	Comparable bond price / (A)(D)	2 to 3 points	9, 10 points
		Option Model	Interest rate - Foreign exchange correlation / (A)(D)	47% to 48%	48%, 48%
		Option Model	Interest rate curve correlation / (A)(D)	36% to 94%	71%, 76%
		Option Model	Interest rate quanto correlation / (A)(D)	-11% to 37%	6%, -8%
		Option Model	Interest rate volatility skew / (A)(D)	25% to 59%	39%, 29%
Financial liabilities designated at fair value through profit or loss:					
- Prepaid OTC contracts	(66)	Option Model	At the money volatility / (C) / (D)	7% to 59%	32%
		Option Model	Cash synthetic basis / (C) / (D)	12 points	12 points
- Other	(25)	Comparable pricing	Comparable bond price / (A)	94 to 111 points	97 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 \$3million not included within one of the major derivative categories.

(2) The ranges of significant unobservable inputs are represented in points, percentages, basis points or times. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point equals 1/100th of 1%; for example, 199 basis points would equal 1.99%.

(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 multi-dimensional form, such as a curve or a 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 (ie. hybrid products)

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. 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	Valuation technique	Significant unobservable input(s) / Sensitivity of the fair value to changes in the unobservable inputs	Range ⁽²⁾	Averages ⁽³⁾
ASSETS	\$millions				
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 / (A)	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/ (decreases) 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. 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

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 ⁽⁵⁾	(754)	Option Model	At the money volatility / (C)(D)	16% to 57%	29%
		Option Model	Volatility skew / (C)(D)	-3% to 0%	-1%
		Option Model	Equity correlation / (C)(D)	40% to 99%	67%
		Option Model	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
		Option Model	Inflation volatility / (A)(D)	77% to 86%	81%, 80%
		Option Model	Interest rate / (A)(D)	0% to 1%	1%, 0%
		Option Model	Net asset value / (A)(D)	\$0 to \$121	\$63
		Option Model	Interest rate - Foreign exchange correlation / (A)(D)	3% to 63%	43%, 48%
		Option Model	Interest rate curve correlation / (A)(D)	46% to 92%	74%, 80%
		Option Model	Interest rate quanto correlation / (A)(D)	-11% to 34%	8%, 5%
		Option Model	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%
		Option Model	Interest rate - Foreign exchange correlation / (A)(D)	3% to 63%	43%, 48%
		Option Model	Interest rate curve correlation / (A)(D)	46% to 92%	74%, 80%
		Option Model	Interest rate quanto correlation / (A)(D)	-11% to 34%	8%, 5%
		Option Model	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 \$3million not included within one of the major derivative categories.
- (2) The ranges of significant unobservable inputs are represented in points, percentages, basis points or times. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point 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 multi-dimensional form, such as a curve or a 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 (ie. hybrid products)

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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)

- *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.
- *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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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. 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)

30 June 2014

	Effect of reasonably possible alternative assumptions		
	Fair value ⁽²⁾	Increase in	Decrease in
	\$millions	fair value	fair value
		\$millions	\$millions
Financial assets classified as held for trading:			
- Government debt securities	10	-	-
- Corporate and other debt	474	14	(7)
- Corporate equities	96	2	(6)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	20	-	-
- Customer loans	1,528	4	(4)
Financial liabilities classified as held for trading:			
- Corporate and other debt	6	-	-
- Corporate equities	9	-	-
- Net derivatives contracts ⁽¹⁾	499	153	(140)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	66	1	(2)
- Structured notes	12	-	-
- Other	25	-	-

(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.

(2) In addition the Group has \$58 million of available-for-sale financial assets classified in Level 3 where it is expected there will be a range of possible alternative values, yet due to the absence of prevailing market evidence it is not possible to estimate a range of reasonably possible alternative values.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

9. 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)

31 December 2013

		Effect of reasonably possible alternative assumptions	
	Fair value ⁽²⁾	Increase in	Decrease in
	\$millions	fair value	fair value
		\$millions	\$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)
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.

(2) In addition the Group has \$58 million of available-for-sale financial assets classified in Level 3 where it is expected there will be a range of possible alternative values, yet due to the absence of prevailing market evidence it is not possible to estimate a range of reasonably possible alternative values

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

9. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

e. Financial instruments valued using unobservable market data

The amounts not recognised in the condensed 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:

	30 June 2014 \$millions	31 December 2013 \$millions
At 1 January	351	559
New transactions	11	60
Amounts recognised in the condensed consolidated income statement during the period	(113)	(268)
At 30 June/ 31 December	249	351

The condensed consolidated statement of financial position categories 'Financial assets and financial liabilities classified as held for trading', 'Financial assets and financial liabilities designated at fair value 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 condensed 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 current or prior period.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

10. ASSETS AND LIABILITIES 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 condensed 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.

30 June 2014

Fair value measurement using:					
			Quoted prices in active market (Level 1)	Valuation techniques using observable inputs (Level 2)	Valuation techniques with significant unobservable inputs (Level 3)
	Carrying value \$millions	Fair value \$millions	\$millions	\$millions	\$millions
Financial liabilities					
Subordinated loans	7,906	8,138	-	8,138	-
Other payables ⁽¹⁾	3,218	2,494	-	2,494	-

(1) Also included in the condensed consolidated statement of financial position is \$8,630 million of Other payables where the carrying value is a reasonable approximation of fair value.

31 December 2013

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

(1) Also included in the condensed consolidated statement of financial position is \$14,981 million of other payables where the carrying value is a reasonable approximation of fair value.

The fair value for subordinated loans has been determined based on the assumption that all subordinated loans are held to the latest repayment date, although the amounts outstanding are repayable at any time at the Group's option, subject to prior consent from the PRA and FCA.

The fair value of other payables is determined based on current interest rates and credit spreads for debt instruments with similar terms and maturity.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2014

11. 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. The subsidiaries that were disposed of 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 were reclassified from the “Currency translation reserve” to the condensed consolidated income statement for the six months ended 30 June 2013 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:

	At disposal \$millions
ASSETS	
Trade receivables	1,899
Financial assets classified as held for trading	<u>1,840</u>
TOTAL ASSETS	<u>3,739</u>
LIABILITIES	
Other payables	1,901
Financial liabilities classified as held for trading	<u>3</u>
TOTAL LIABILITIES	<u>1,904</u>
NET ASSETS	<u>1,835</u>
Total consideration received	1,835
Reclassification of net cumulative translation losses	<u>151</u>
Loss on disposal	<u><u>151</u></u>

12. RELATED PARTY DISCLOSURES

The management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. For the six month period ended 30 June 2014, \$326 million was transferred to other Morgan Stanley Group undertakings relating to such policies and recognised in the condensed consolidated income statement (six month period ended 30 June 2013: \$461 million).

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six months ended 30 June 2014

13. LITIGATION

In the normal course of business, the Group has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/ or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress. These actions have included, but are not limited to, residential mortgage and credit crisis related matters. Over the last several years, the level of litigation and investigatory activity (both formal and informal) by governmental and self-regulatory agencies 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 any individual proceedings where the Group believes a material loss to be reasonably possible and reasonably estimable, there can be no assurance that material losses will not be incurred from claims that have not yet been asserted or are not yet determined to be probable or possible and reasonably estimable losses.

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 condensed consolidated financial statements and the Group can reasonably estimate the amount of that loss, the Group accrues the estimated loss by a charge to income. 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.

In many proceedings and investigations, however, it is inherently difficult to determine whether any loss is probable or even possible or to estimate the amount of any loss. In addition, even where loss is possible or an exposure to loss exists in excess of the liability already accrued with respect to a previously recognised loss contingency, it is not always possible to reasonably estimate the size of the possible loss or range of loss.

For certain legal proceedings and investigations, the Group cannot reasonably estimate such losses, particularly for proceedings and investigations where the factual record is being developed or contested or where plaintiffs or governmental 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 and investigations, 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 condensed consolidated financial statements as a whole, other than the matters referred to in the following paragraphs.

On 25 March 2014, the court in *Ge Dandong, et al. v. Pinnacle Performance Ltd. et al.* denied the defendants' petition seeking permission to appeal the court's decision granting class certification. On 17 July 2014, the parties reached an agreement in principle to settle the litigation. The settlement is subject to court approval.

The Group, other Morgan Stanley Group undertakings and the other recipients of the Statement of Objections issued by the European Commission ("EC") in July 2013 with respect to the development of exchange traded credit default swap products attended oral hearings before the EC during the period 12 to 19 May 2014. The Group's and other Morgan Stanley Group undertakings' oral hearing took place on 15 May 2014.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS **Six months ended 30 June 2014**

13. LITIGATION (CONTINUED)

On 8 May 2014, the California Attorney General's Office ("CAAG") indicated that it has made certain preliminary conclusions including that the Morgan Stanley Group knowingly caused material misrepresentations to be made regarding the Cheyne SIV, which issued securities marketed to the California Public Employees Retirement System. The CAAG has further indicated that it believes the Morgan Stanley Group's conduct violated California law and that it may seek treble damages, penalties and injunctive relief. The Morgan Stanley Group does not agree with these conclusions and has presented defences to them to the CAAG.