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MORGAN STANLEY & CO. INTERNATIONAL plc

Report and financial statements

31 December 2014

MORGAN STANLEY & CO. INTERNATIONAL plc

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MORGAN STANLEY & CO. INTERNATIONAL plc

STRATEGIC REPORT

The Directors present their Strategic report for Morgan Stanley & Co. International plc (the “Company”) and all of its subsidiary undertakings (together “the Group”) for the year ended 31 December 2014.

PRINCIPAL ACTIVITY

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

The Company operates branches in the Dubai International Financial Centre, France, South Korea, the Netherlands, Poland, the Qatar Financial Centre and Switzerland. On 15 December 2014 the Company’s New Zealand branch was closed.

There have not been any changes in the Group’s principal activity in the year under review and no significant change in the Group’s principal activity is expected other than on 16 December 2014 the Directors of Morgan Stanley Securities Limited (“MSSL”), another Morgan Stanley Group undertaking incorporated in the United Kingdom (“UK”), agreed to transfer its institutional securities business to the Group. The transfer was substantially completed in the first quarter of 2015. This transferred business is expected to have a positive impact on the Group’s results.

In addition, on 20 December 2013 a Purchase Agreement was entered into between Morgan Stanley and a subsidiary of Rosneft Oil Company (“Rosneft”) pursuant to which the Morgan Stanley Group would sell the global oil merchanting unit of its commodities division to Rosneft. On 22 December 2014 Morgan Stanley announced the termination of the sale due to the expiration of the Purchase Agreement on 20 December 2014. Morgan Stanley continues to explore strategic options for its global oil merchanting business, which includes the oil merchanting unit operated within the Group.

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

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

BUSINESS REVIEW

Global market and economic conditions

During 2014, global market and economic conditions displayed a continued but choppy improvement from 2013, characterised by continued global central bank accommodations, low inflation, geopolitical tensions, and sharply lower oil prices during the final months of the year. The US economy, which started 2014 with a weather-impacted first quarter decline in gross domestic product (“GDP”), ended the year with an annualised GDP growth rate of 2.4%. The Eurozone economy, by contrast, stalled in the second quarter before showing some signs of improvement in the second half of the year, as the annexation of the Crimea region in Ukraine by Russia and conflict in Eastern Ukraine raised anxiety and tensions which weighed on regional economies. In the UK, GDP growth continued to accelerate, with an annualised growth rate of 2.6% for all of 2014, while the Japanese economy saw substantial volatility surrounding a national sales tax hike to 8% from 5% in April, resulting in a GDP growth rate near zero for all of 2014. In China, the government continued reforms to change the structure of the Chinese economy, accepting a somewhat less rapid growth pace as deleveraging is pursued, but targeted easing measures by the Chinese central bank supported a 7.4% gain in real GDP in 2014.

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STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Global market and economic conditions (continued)

In Europe, major equity market indices ended the year lower compared to 31 December 2013 except for the DAX 30 index in Germany, which ended the year with a 2.7% gain. Euro-area GDP growth turned positive after declining in 2013, but the recovery was sluggish at less than 1% for 2014, and market-based measures of Eurozone inflation expectations fell well below levels consistent with the European Central Bank's ("ECB") 2% inflation target, prompting an announcement of additional easing measures in September 2014, including a cut in the benchmark repurchase rate to 0.05% from 0.25% and in the deposit facility rate to negative 0.20% from 0.00% at the end of 2013, and the announcement of asset-backed securities and covered bond purchase programs. In January 2015, the ECB announced and began the expansion of an asset purchase program involving the purchase of Euro-area sovereign debt. In the UK stronger GDP growth in 2014 was supported by faster growth in consumer spending, business investment and residential investment, but export performance was sluggish. The UK continued to experience significant declines in unemployment, while average wage gains remained tepid, and inflation fell below the Bank of England's ("BOE") target. At 31 December 2014, the BOE's benchmark interest rate was 0.5%, which was unchanged from 31 December 2013, and BOE asset purchases remained at £375 billion, also unchanged from 31 December 2013.

Overview of 2014 Financial Results

The consolidated income statement for the year is set out on page 17. The Group reported a loss after tax for the year of \$713 million, compared to a profit after tax of \$37 million for the year ended 31 December 2013.

The Group's revenues are best reviewed across the aggregate of 'Net gains on financial instruments classified as held for trading', 'Net gains on financial instruments designated at fair value through profit or loss', 'Net gains on available-for-sale financial assets', 'Interest income', 'Interest expense' and 'Other income' ("aggregate revenues"). Aggregate revenues for the year decreased by 8% to \$3,881 million compared to \$4,232 million in 2013.

Aggregate revenues in 2014 include a charge of \$273 million related to the implementation of Funding Valuation Adjustments ("FVA") (see note 2). This charge was a key driver in the reduction in fixed income and commodities ("FIC") sales and trading revenues. Aggregate revenues were also impacted by a decrease in equity sales and trading revenues, partially offset by an increase in investment banking revenues.

In addition to the negative impact of the FVA implementation, FIC sales and trading revenues were negatively impacted by a decrease in commodities revenues, mainly related to its oil business. Partially offsetting these decreases was an increase in revenues from interest rate products.

Equity sales and trading revenues decreased during the year compared to 2013, primarily due to a decrease in derivatives revenues, reflecting unfavourable volatility movement, partially offset by an increase in prime brokerage revenues, mainly due to increased client activity.

Investment banking revenues increased as a result of stronger advisory and underwriting revenues across most products.

Aggregate results for the year exclude net day one gains of \$26 million (2013: \$60 million gains) not recognised upon initial recognition of financial instruments measured at fair value where valuation techniques include unobservable market data (see note 31(e)).

Other expense increased from \$3,908 million in 2013 to \$4,558 million in 2014. Staff costs borne directly by the Group and through management recharges from other Group undertakings, increased by 17% from \$2,056 million in 2013 to \$2,414 million in 2014. A decrease in the average deferral rate for 2014 discretionary incentive compensation awards and the acceleration of vesting for certain outstanding cash based incentive compensation awards have contributed to this increase (see note 7). The other main driver of the increase in 'Other expense' is an increase of \$341 million in 'net management charges from other Morgan Stanley Group undertakings relating to other services', resulting in a charge of \$670 million in 2014.

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STRATEGIC REPORT

BUSINESS REVIEW (CONTINUED)

Overview of 2014 Financial Results (continued)

This increase was mainly due to adjustments made to (i) the recharge of relationship lending costs received by the Group from other Morgan Stanley Group undertakings and (ii) the recharge to other Morgan Stanley Group undertakings of certain stock lending costs incurred by the Group. A proportion of these costs were related to the prior year.

The Group incurred a tax charge for the year of \$36 million (2013: \$136 million). A tax charge was recognised by the Group despite making a loss before tax due mainly to the transfer of taxable losses outside of the Group for nil consideration and the impact of withholding taxes and foreign branch taxes suffered which are not available for double tax relief due to the reduced profitability of the Group. These charges were partially offset by a tax credit related to a reduction in an overseas tax provision (see note 8).

The consolidated statement of financial position is presented on page 20. The Group continued to focus on strengthening its capital position and reducing its balance sheet. The Group issued \$1,300 million of Additional Tier 1 capital, increasing its equity to \$16,188 million at 31 December 2014 (2013: \$15,659 million).

The Group's total assets and liabilities decreased by \$45,000 million and \$45,529 million respectively, a decrease of 9% and 10% respectively as at 31 December 2014 when compared to the restated ⁽¹⁾ total assets and total liabilities as at 31 December 2013. The decrease in total assets is driven by decreases in financial assets held for trading of \$33,076 million and securities purchased under agreements to resell of \$16,993 million. The decrease in total liabilities is driven by decreases in financial liabilities classified as held for trading of \$22,786 million and securities sold under agreements to repurchase of \$24,105 million. The decreases in financial assets held for trading and financial liabilities classified as held for trading were mainly due to decreases in derivative assets and liabilities as a result of increased netting benefits (see note 30). The decreases in securities purchased under agreements to resell and securities sold under agreements to repurchase were due to decreased client and firm financing activities.

The consolidated statement of cash flows presented on page 21 shows a net decrease in cash of \$491 million during the year (2013: net increase of \$669 million). Net cash flows used in operating activities were \$1,578 million (2013: \$3,026 million), offset by proceeds from the issue of Additional Tier 1 capital of \$1,300 million (2013: net increase in equity instruments of \$2,000 million). Interest paid on subordinated debt was \$138 million (2013: \$123 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:

2014 Profitability metrics – The Group's operating margin (defined as net loss/ profit before tax as a percentage of aggregate revenues) was negative 17.4%. Its return on equity (loss for the year as a percentage of total equity at the beginning of the year) was negative 4.6% and its return on assets (loss for the year as a percentage of total assets at the end of the year) was negative 0.1%.

Balance Sheet Assets – Reducing the Group's total assets has been, and continues to be, a focus of the Group. The Group's restated total assets, as disclosed on page 20, decreased by 9% to \$449 billion at 31 December 2014.

Capital – The Group took steps during the year to improve its capital position in light of losses generated in the Group, the implementation of Basel III in 2014 and leverage rules which are due to be phased in over future years. The Group increased its equity by \$1,300 million during the year to \$16,188 million at 31 December 2014 (2013: \$15,659 million).

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 2014 was \$19 million compared with \$22 million for 2013 and was below internal risk management targets.

(1) Details of the restatement are provided in note 2.

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STRATEGIC REPORT

Risk management

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

Note 27 to the consolidated financial statements provides more detailed qualitative and quantitative disclosures about the Group's management of and exposure to financial risks.

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

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities, 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 key 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 individual legal entity within the Group.

The Group's Management VaR is a useful indicator of possible trading losses resulting from adverse daily market movements. The average VaR for the Primary Risk Categories for 2014 was \$17 million compared with \$20 million for 2013, with the decrease being mainly due to reduced exposure to equity price. The average Credit Portfolio VaR for 2014 was \$6 million compared with \$8 million for 2013, with this decrease being due to decreased counterparty exposure during 2014. The average total Management VaR for 2014 was \$19 million compared with \$22 million for 2013.

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. Credit risk includes the risk that economic, social and political conditions and events in a foreign country will adversely affect an obligor's ability and willingness to fulfill their obligations. 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.

STRATEGIC REPORT

Risk management (continued)

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.

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 exposures in the Peripheral European countries (Greece, Ireland, Italy, Portugal and Spain) may also be considered. The Group also conducts legal and documentation analysis of its exposures to obligors in Peripheral jurisdictions 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. The Group continues to closely monitor and manage all of its principal risks and exposures, in particular, in light of ongoing developments in Europe concerning Ukraine and Russia. The Group's exposure to Ukraine and Russia is limited. As at 31 December 2014 its net country risk exposure to Russia was \$160 million, while in Ukraine the Group had a net short position of \$16 million. 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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STRATEGIC REPORT

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	Funded lending \$millions	Unfunded commitments \$millions	Exposure before hedges \$millions	Hedges ⁽³⁾ \$millions	Net exposure ⁽⁴⁾ \$millions
Germany							
Sovereigns	1,369	233	-	-	1,602	(881)	721
Non-sovereigns	(208)	2,142	24	69	2,027	(236)	1,791
Total Germany	1,161	2,375	24	69	3,629	(1,117)	2,512
United States							
Sovereigns	(171)	420	-	-	249	-	249
Non-sovereigns	(346)	1,683	-	-	1,337	(21)	1,316
Total United States	(517)	2,103	-	-	1,586	(21)	1,565
France							
Sovereigns	(1,235)	-	-	-	(1,235)	-	(1,235)
Non-sovereigns	161	1,663	-	1,349	3,173	(375)	2,798
Total France	(1,074)	1,663	-	1,349	1,938	(375)	1,563
The People's Republic of China							
Sovereigns	340	113	-	-	453	-	453
Non-sovereigns	684	176	-	-	860	(8)	852
Total The People's Republic of China	1,024	289	-	-	1,313	(8)	1,305
Belgium							
Sovereigns	755	-	-	-	755	-	755
Non-sovereigns	218	47	-	-	265	(17)	248
Total Belgium	973	47	-	-	1,020	(17)	1,003

- (1) Net inventory represents exposure to both long and short single-name and index positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable). As a market maker, the Group transacts in these CDS positions to facilitate client trading.
- (2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.
- (3) Represents CDS hedges (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (4) In addition, as at 31 December 2014, the Group had exposure to these countries for overnight deposits with banks of approximately \$709 million, comprising of The People's Republic of China of \$438 million, the United States of \$206 million and Western Europe of \$65 million.

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STRATEGIC REPORT

Risk management (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	14	-	-	-	14	(4)	10
Non-sovereigns	15	4	-	-	19	-	19
Total Greece	29	4	-	-	33	(4)	29
Ireland							
Sovereigns	(75)	8	-	5	(62)	-	(62)
Non-sovereigns	240	55	-	-	295	-	295
Total Ireland	165	63	-	5	233	-	233
Italy							
Sovereigns	1,038	12	-	138	1,188	(112)	1,076
Non-sovereigns	415	428	242	22	1,107	(88)	1,019
Total Italy	1,453	440	242	160	2,295	(200)	2,095
Portugal							
Sovereigns	62	(1)	-	-	61	12	73
Non-sovereigns	187	10	-	25	222	(2)	220
Total Portugal	249	9	-	25	283	10	293
Spain							
Sovereigns	427	5	-	5	437	-	437
Non-sovereigns	21	339	96	-	456	(51)	405
Total Spain	448	344	96	5	893	(51)	842
Sovereigns	1,466	24	-	148	1,638	(104)	1,534
Non-sovereigns	878	836	338	47	2,099	(141)	1,958
Total European Peripherals	2,344	860	338	195	3,737	(245)	3,492

- (1) Net inventory represents exposure to both long and short single-name and index positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable). As a market maker, the Group transacts in these CDS positions to facilitate client trading.
- (2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) takes into consideration legally enforceable master netting agreements and collateral.
- (3) CDS adjustment represents credit protection purchased from European Peripherals' banks on European Peripherals' sovereign and financial institution risk. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (4) Represents CDS hedges (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.
- (5) In addition, as at 31 December 2014, the Group had European Peripherals exposure for overnight deposits with banks of approximately \$20 million.

STRATEGIC REPORT

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 its Liquidity Reserve, which are further described in note 27.

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 globally.

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, regulatory and compliance risks but excludes strategic risk. Operational risk relates to the following risk event categories as defined by Basel II: internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; business disruption and system failure; damage to physical assets; and execution, delivery and process management.

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 risks in the context of an approved risk tolerance 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 global markets. In addition, new products or services may be introduced that impact or change business processes, thereby resulting in new operational risks that may not have been fully anticipated or identified. In general, the transactions processed are increasingly complex. The Group relies on the ability of the Morgan Stanley Group's employees, 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 financial intermediaries it uses to facilitate securities/ client transactions. In the event of a breakdown or unauthorised or improper operation of the Group's or a third party's systems, the Group could suffer financial loss, an impairment to its liquidity, a disruption of its businesses, regulatory sanctions or reputation damage. In addition, the interconnectivity of multiple financial institutions with central agencies, exchanges and clearing houses, and the increased interconnectivity of these entities, increases the risk that an operational risk failure at one institution or entity may cause an industry-wide operational failure that could materially impact the Group's ability to conduct business.

STRATEGIC REPORT

Risk management (continued)

Operational risk (continued)

The Group's operations rely on the secure processing, storage and transmission of confidential and other information in its computer systems and the systems of third parties with which the Group does business with or that facilitate its business activities, such as external vendors and third-party suppliers. 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 of information, computer viruses or malware cyber-attacks, designed to obtain confidential information, destroy data, disrupt or degrade service, sabotage systems or cause other system damage. If one or more of these events occur, the events 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, 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 with our clients and the market, client dissatisfaction, additional cost to repair systems, add new protective technologies and/ or personnel, regulatory investigations, litigation or regulatory fines or penalties not covered by insurance maintained by the Group, all or which adversely affect the business, financial condition and results of operations.

Legal, regulatory and compliance risk

The Group is exposed to legal, regulatory and compliance risks, which include the risk of legal or regulatory sanctions, material financial loss; such as fines, penalties, judgements, damages and/ or settlements or loss to reputation the Group may suffer as a result of failure to comply with laws, regulations, rules, self-regulatory organisation standards and codes of conduct applicable to business activities. Legal risks also include contractual and commercial risks in the event 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 changes, the Group also views regulatory changes 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 followed globally. In connection with its businesses, the Group 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 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.

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STRATEGIC REPORT

Risk management (continued)

Culture, Values and Conduct of Employees

All of the Morgan Stanley Group's employees have accountability for risk management. The Morgan Stanley Group strives to establish a culture of effective risk management through its defined core values, governance framework, management oversight, training and development programs, policies, procedures, and defined roles and responsibilities within the Morgan Stanley Group. The actions and conduct of each employee are essential to risk management. The Morgan Stanley Group's Code of Conduct (the "Code") has been established to provide a framework and standards for employee conduct that further reinforces the Morgan Stanley Group's commitment to integrity and high ethical standards. Every new hire and every employee annually must certify to their understanding of and adherence to the Code. The employee annual review process includes evaluation of adherence to the Code. The Global Incentive Compensation Discretion Policy sets forth standards that specifically provide that managers must consider whether the employee effectively managed and supervised the risk control practices of his/ her employee reports during the performance year. The Morgan Stanley Group has several mutually reinforcing processes to identify incidents of employee conduct that may have an impact on the employment status, current year compensation or prior year compensation. The Morgan Stanley Group's clawback and cancellation provisions permit recovery of deferred incentive compensation where, for example, an employee's act or omission (included with respect to direct supervisory responsibilities) causes a restatement of the Morgan Stanley Group's consolidated financial results, constitutes a violation of the Morgan Stanley Group's global risk management principles, policies and standards, or causes a loss of revenue associated with a position on which the employee was paid and the employee operated outside of internal control policies.

Capital management

The Group views capital as an important source of financial strength. It actively manages and monitors its capital in line with established policies and procedures and in compliance with local regulatory requirements. The Group further strengthened its capital position during the year through the issuance of Additional Tier 1 capital instruments of \$1,300 million to Morgan Stanley UK Group. The Group's capital management is further described in note 33.

Going Concern

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

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

Approved by the Board and signed on its behalf by



C Castello

Director

22 April 2015

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

The Directors present their report and consolidated financial statements of Morgan Stanley & Co. International plc (the "Company") and all of its subsidiary undertakings (together "the Group"), which comprise the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity, consolidated statement of financial position, consolidated statement of cash flows and the related notes 1 to 36, together with the Company's balance sheet and related notes 1 to 20 for the year ended 31 December 2014.

RESULTS AND DIVIDENDS

The Group's loss for the year, after tax, was \$713 million (2013: \$37 million profit after tax).

During the year, a dividend of \$88 million was paid on the Class D1 preference shares although this dividend was declared and therefore accrued as at 31 December 2013. No other dividends were proposed or paid during the year ended 31 December 2014. In 2013, a dividend of \$1 million was paid on the Class C preference shares. No final dividends are proposed (2013: \$nil).

On 22 January 2015, the Directors approved a coupon payment on the Additional tier 1 capital instruments of \$15 million (see note 23).

REGULATION

The Company is authorised by the Prudential Regulation Authority ("PRA") and regulated by the Financial Conduct Authority ("FCA") and the PRA. In addition, the Company is a registered swap dealer and is regulated by the US Commodity Futures Trading Commission.

RISK MANAGEMENT, BRANCHES AND FUTURE DEVELOPMENTS

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

PILLAR 3 DISCLOSURES

The regulatory disclosures made in order to comply with the European Union ("EU") Directives and Regulation implementing the Basel capital framework ("the Pillar 3 disclosures") are available on the Morgan Stanley website (see note 33 for further details).

COUNTRY-BY-COUNTRY REPORTING

The disclosures made in order to comply with the Capital Requirements (Country-by-Country Reporting) Regulations 2013 will be made available on the Morgan Stanley website (see note 33 for further details).

DIRECTORS

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

L Bini Smaghi	(resigned 31 March 2014)
C D S Bryce	(resigned 18 September 2014)
D O Cannon	
C Castello	(appointed 21 January 2015)
Sir E J W Gieve	
L Guy	(appointed 20 November 2014)
T C Kelleher	(resigned as Chairman 1 January 2014)
F R Petitgas	(resigned 18 September 2014)
M C Phibbs	
I Plenderleith	(appointed as Chairman 1 January 2014)
R P Rooney	
D A Russell	
C E Woodman	

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

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

DIRECTORS' INDEMNITY

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

AUDIT COMMITTEE

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

EMPLOYEES

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

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

EMPLOYEE REMUNERATION

The Group employs staff directly, in addition to utilising staff employed by other Morgan Stanley Group undertakings. The Group's policies are comparable and consistent with those of the Morgan Stanley Group, which include the deferral of significant portions of certain key employees' discretionary compensation. Notes 7 and 34 to the consolidated financial statements provides additional information and disclosure regarding the Group's compensation policies.

CHARITABLE CONTRIBUTIONS

During the year the Group made donations to various charities totalling \$2.1 million (2013: \$2.2 million), of which \$1.5 million was donated to the Morgan Stanley International Foundation (2013: \$1.4 million).

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

AUDITOR

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

Statement as to disclosure of information to the auditor

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

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

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

Approved by the Board and signed on its behalf by



C Castello

Director

22 April 2015

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

DIRECTORS' RESPONSIBILITIES STATEMENT

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

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the financial statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the EU and Article 4 of the International Accounting Standards ("IAS") Regulation. Under company law the Directors must not approve the accounts unless they are satisfied that they give a true and fair view of the state of affairs of the Group and of the profit or loss of the Group for that period.

In preparing the Group financial statements, the Directors are required by IAS 1 '*Presentation of financial statements*' ("IAS 1") to:

- (a) properly select and apply accounting policies;
- (b) present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- (c) provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- (d) make an assessment of the Group's ability to continue as a going concern.

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

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

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

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

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

Approved by the Board and signed on its behalf by



C Castello

Director

22 April 2015

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

We have audited the Group and Company financial statements of Morgan Stanley & Co. International plc for the year ended 31 December 2014 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity, the consolidated statement of financial position and the consolidated statement of cash flows and the Company balance sheet and the related notes 1 to 36 for the consolidated financial statements and the related notes 1 to 20 for the Company financial statements. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and IFRS as adopted by the EU. The financial reporting framework that has been applied in the preparation of the Company financial statements is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

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

Respective responsibilities of Directors and auditor

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

Scope of the audit of the financial statements

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

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Group's and of the parent Company's affairs as at 31 December 2014 and of its loss for the year then ended;
- for the Group have been properly prepared in accordance with IFRS as adopted by the European Union;
- for the Company have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

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

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

Matters on which we are required to report by exception

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

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



Robert Topley (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London
22 April 2015

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED INCOME STATEMENT Year ended 31 December 2014

	Note	2014 \$millions	Restated 2013 \$millions
Net gains on financial instruments classified as held for trading		2,775	3,281
Net gains on financial instruments designated at fair value through profit or loss		80	135
Net gains on available-for-sale financial assets	4	1	5
Interest income	5	708	1,217
Interest expense	5	(938)	(1,610)
Other income	6	1,255	1,204
Other expense	7	(4,558)	(3,908)
Net currency translation loss on disposal of subsidiaries	14	-	(151)
(LOSS)/PROFIT BEFORE INCOME TAX		<u>(677)</u>	<u>173</u>
Income tax expense	8	(36)	(136)
(LOSS)/PROFIT FOR THE YEAR		<u>(713)</u>	<u>37</u>
Attributable to:			
Owners of the parent		(714)	35
Non-controlling interests		1	2
(LOSS)/PROFIT FOR THE YEAR		<u>(713)</u>	<u>37</u>

All operations were continuing in the current and prior year.

The notes on pages 22 to 124 form an integral part of the consolidated financial statements.

Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
Year ended 31 December 2014

	Note	2014 \$millions	2013 \$millions
(LOSS)/ PROFIT FOR THE YEAR		(713)	37
OTHER COMPREHENSIVE INCOME, NET OF TAX			
Items that will not be reclassified subsequently to profit or loss:			
Remeasurement of net defined benefit liability	8	2	2
Items that may be reclassified subsequently to profit or loss:			
Currency translation reserve:			
Foreign currency translation differences arising on foreign operations		(60)	35
Net loss reclassified to the consolidated income statement	14	-	151
Available-for-sale reserve:			
Net change in fair value of the available-for-sale financial assets	8	2	4
Net amount reclassified to the consolidated income statement	8	-	(4)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	8	(2)	(2)
OTHER COMPREHENSIVE (LOSS)/ INCOME AFTER INCOME TAX FOR THE YEAR		(58)	186
TOTAL COMPREHENSIVE (LOSS)/ INCOME FOR THE YEAR		<u>(771)</u>	<u>223</u>
Attributable to:			
Owners of the parent		(763)	218
Non-controlling interests		(8)	5
TOTAL COMPREHENSIVE (LOSS)/ INCOME FOR THE YEAR		<u>(771)</u>	<u>223</u>

The notes on pages 22 to 124 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

Year ended 31 December 2014

Note	Equity instruments \$millions	Share premium \$millions	Currency translation reserve \$millions	Available-for-sale reserve \$millions	Capital contribution reserve \$millions	Capital redemption reserve \$millions	Pension 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
Profit for the year	-	-	-	-	-	-	-	35	35	2	37
Other comprehensive income/ (loss):											
Remeasurement of net defined benefit liability	-	-	-	-	-	-	-	2	2	-	2
Currency translation reserve:											
Foreign currency translation differences arising on foreign operations	-	-	32	-	-	-	-	-	32	3	35
Net amount reclassified to consolidated income statement	14	-	151	-	-	-	-	-	151	-	151
Available-for-sale reserve:											
Net change in fair value of available-for-sale financial assets	8	-	-	4	-	-	-	-	4	-	4
Net amount reclassified to consolidated income statement	8	-	-	(4)	-	-	-	-	(4)	-	(4)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	8	-	-	-	-	-	-	(2)	(2)	-	(2)
Total comprehensive income/ (loss)	-	-	183	-	-	-	-	35	218	5	223
Transactions with owners:											
Issue of ordinary share capital	22	3,050	-	-	-	-	-	-	3,050	-	3,050
Repurchase of preference shares	22	(1,050)	-	-	-	-	-	-	(1,050)	-	(1,050)
Dividends	23	-	-	-	-	-	-	(89)	(89)	-	(89)
Balance at 31 December 2013	11,464	513	78	4	3	1,400	-	2,118	15,580	79	15,659
(Loss)/ profit for the year	-	-	-	-	-	-	-	(714)	(714)	1	(713)
Other comprehensive income/ (loss):											
Remeasurement of net defined benefit liability	-	-	-	-	-	-	2	-	2	-	2
Currency translation reserve:											
Foreign currency translation differences arising on foreign operations	-	-	(51)	-	-	-	-	-	(51)	(9)	(60)
Available-for-sale reserve:											
Net change in fair value of available-for-sale financial assets	8	-	-	2	-	-	-	-	2	-	2
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	8	-	-	-	-	-	-	(2)	(2)	-	(2)
Total comprehensive income/ (loss)	-	-	(51)	2	-	-	2	(716)	(763)	(8)	(771)
Transactions with owners:											
Issue of Additional Tier 1 capital	22	1,300	-	-	-	-	-	-	1,300	-	1,300
Balance at 31 December 2014	12,764	513	27	6	3	1,400	2	1,402	16,117	71	16,188

The notes on pages 22 to 124 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

Registered number: 2068222

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

As at 31 December 2014

	Note	2014 \$millions	Restated 31 December 2013 \$millions	Restated 1 January 2013 \$millions
ASSETS				
Loans and receivables:				
Cash and short term deposits	24	11,671	12,244	11,526
Cash collateral on securities borrowed		20,691	17,372	19,733
Securities purchased under agreements to resell		58,724	75,717	99,782
Trade receivables		54,944	48,629	46,499
Other receivables	10	3,317	2,965	5,676
		<u>149,347</u>	<u>156,927</u>	<u>183,216</u>
Financial assets classified as held for trading (of which \$43,572 million (2013: \$45,178 million) were pledged to various parties)	11	295,398	328,474	339,549
Financial assets designated at fair value through profit or loss	12	3,360	7,673	7,591
Available-for-sale financial assets	13	42	60	40
Current tax assets		217	229	210
Deferred tax assets	20	86	115	91
Prepayments and accrued income		72	43	53
Property, plant and equipment	16	4	5	7
TOTAL ASSETS		<u>448,526</u>	<u>493,526</u>	<u>530,757</u>
LIABILITIES AND EQUITY				
Financial liabilities at amortised cost:				
Bank loans and overdrafts	24	15	16	23
Cash collateral on securities loaned		17,499	13,457	17,766
Securities sold under agreements to repurchase		45,911	70,016	85,694
Trade payables		83,561	74,056	63,443
Subordinated loans	17	7,906	7,906	7,906
Other payables	18	14,134	18,179	17,616
		<u>169,026</u>	<u>183,630</u>	<u>192,448</u>
Financial liabilities classified as held for trading	11	257,828	280,614	311,682
Financial liabilities designated at fair value through profit or loss	12	5,131	13,123	12,560
Provisions	19	43	30	82
Current tax liabilities		105	242	243
Deferred tax liabilities	20	1	3	4
Accruals and deferred income		199	221	208
Post employment benefit obligations	35	5	4	5
TOTAL LIABILITIES		<u>432,338</u>	<u>477,867</u>	<u>517,232</u>
EQUITY				
Equity instruments	22	12,764	11,464	9,464
Share premium account		513	513	513
Currency translation reserve		27	78	(105)
Available-for-sale reserve		6	4	4
Capital contribution reserve		3	3	3
Capital redemption reserve		1,400	1,400	1,400
Pension reserve		2	-	-
Retained earnings		1,402	2,118	2,172
Equity attributable to the owners of the parent		<u>16,117</u>	<u>15,580</u>	<u>13,451</u>
Non-controlling interests		<u>71</u>	<u>79</u>	<u>74</u>
TOTAL EQUITY		<u>16,188</u>	<u>15,659</u>	<u>13,525</u>
TOTAL LIABILITIES AND EQUITY		<u>448,526</u>	<u>493,526</u>	<u>530,757</u>

These consolidated financial statements were approved by the Board and authorised for issue on 22 April 2015. Signed on behalf of the Board:

C Castello
Director



The notes on pages 22 to 124 form an integral part of the consolidated financial statements.
Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED STATEMENT OF CASH FLOWS
Year ended 31 December 2014

	Note	2014 \$millions	2013 \$millions
NET CASH FLOWS USED IN OPERATING ACTIVITIES	24b	(1,578)	(3,026)
INVESTING ACTIVITIES			
Purchase of property, plant and equipment	16	(2)	(1)
Purchase of available-for-sale financial assets		-	(27)
Proceeds from disposal of available-for-sale financial assets		15	12
Proceeds from disposal of subsidiaries, net of cash disposed	14	-	1,835
NET CASH FLOWS FROM INVESTING ACTIVITIES		<u>13</u>	<u>1,819</u>
FINANCING ACTIVITIES			
Issue of equity instruments	22	1,300	3,050
Repurchase of preference shares	22	-	(1,050)
Dividends paid to owners of the parent	23	-	(1)
Dividends paid on preference shares	23	(88)	-
Interest on subordinated loan liabilities		(138)	(123)
NET CASH FLOWS FROM FINANCING ACTIVITIES		<u>1,074</u>	<u>1,876</u>
NET (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS		(491)	669
Currency translation differences on foreign currency cash balances		(81)	56
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	24a	<u>12,228</u>	<u>11,503</u>
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	24a	<u><u>11,656</u></u>	<u><u>12,228</u></u>

The notes on pages 22 to 124 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

1. CORPORATE INFORMATION

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

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

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

2. BASIS OF PREPARATION

Statement of compliance

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

New standards and interpretations adopted during the year

The following amendments to standards and interpretations relevant to the Group's operations were adopted during the year. Except where otherwise stated, these amendments to standards and interpretations did not have a material impact on the Group's 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 10"), IFRS 12 '*Disclosure of interests in other entities*' and IAS 27 '*Consolidated and separate financial statements*' 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. The interpretation 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 year.

New standards and interpretations not yet adopted

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

An amendment to IAS 1 '*Disclosure initiative*' was issued by the IASB in December 2014, for application in annual periods beginning on or after 1 January 2016.

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 CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

2. BASIS OF PREPARATION (CONTINUED)

New standards and interpretations not yet adopted (continued)

An amendment to IAS 19 was issued by the IASB in November 2013, for retrospective application for annual periods beginning on or after 1 July 2014. The amendment was endorsed by the EU in December 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. IFRS 9 is applicable retrospectively, except where otherwise prescribed by the transitional provisions of the standard, and 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.

Amendments to IFRS 10 and IAS 28 '*Sale or contribution of assets between an investor and its associate or joint venture*' were issued by the IASB in September 2014 for prospective application to transactions occurring in annual periods beginning on or after 1 January 2016.

Amendments to IFRS 10, IFRS 12 and IAS 28 '*Investment entities: Applying the consolidation exemption*' were issued by the IASB in December 2014 for retrospective application in annual periods beginning on or after 1 January 2016.

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.

As part of the December 2013 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 2 '*Share-based payment*' ("IFRS 2"), IFRS 3 '*Business combinations*', IFRS 8 '*Operating segments*', IFRS 13 '*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). The improvements were endorsed by the EU in December 2014.

As part of the September 2014 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 7 '*Financial instruments: Disclosures*', IAS 19 and IAS 34 '*Interim financial reporting*' (for application in accounting periods beginning on or after 1 January 2016).

Basis of measurement

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

Restatement of comparative amounts

In 2014 the Group changed its accounting policy for regular-way sales and purchases of held for trading non-derivative financial instruments from trade date to settlement date accounting. The Group believes that recognising and derecognising held for trading non-derivative financial instruments on settlement date results in a more relevant and reliable presentation of its financial position. Aligning recognition of all non-derivative financial instruments to a settlement date basis, more appropriately reflects the risks of these unsettled positions within the consolidated statement of financial position and results in greater comparability to the financial position of other peer organisations in the UK and the Morgan Stanley Group.

Previously, regular-way purchases and sales of held for trading non-derivative financial instruments were recorded on a trade date basis. As at 31 December 2014, the Group recognised such transactions on a settlement date.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

2. BASIS OF PREPARATION (CONTINUED)

Restatement of comparative amounts (continued)

This resulted in a change to the timing of recognition and derecognition of certain non-derivative financial instruments, as well as significantly reducing the resulting trade receivables and trade payables on the consolidated statement of financial position. This accounting policy change did not have an impact on the profit or loss recorded on those instruments. A fuller description of how these financial instruments are accounted for under settlement date accounting is presented in accounting policy note 3(c) i) 'Financial instruments classified as held for trading'.

Pursuant to the requirements of IAS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', the Group has adjusted comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied and a third consolidated statement of financial position, as at 1 January 2013, has been presented.

This change in accounting policy had the following impact:

As at:	31 December 2014 \$millions	31 December 2013 \$millions	1 January 2013 \$millions
Decrease in trade receivables	16,737	23,591	19,939
Decrease in financial assets classified as held for trading	962	2,449	2,145
Decrease in total assets	<u>17,699</u>	<u>26,040</u>	<u>22,084</u>
Decrease in trade payables	18,186	23,890	19,718
(Increase)/ decrease in financial liabilities classified as held for trading	(487)	2,150	2,366
Decrease in total liabilities	<u>17,699</u>	<u>26,040</u>	<u>22,084</u>

Notes 11, 24(b), 25, 26, 27, 31 and 36 have also been revised as a result of this change in accounting policy.

There is no impact on the consolidated income statement as a result of this change in policy in either the current or prior periods.

In addition, 'Other income' for the year ended 31 December 2013 has been revised primarily to include underwriting fees. Underwriting fees were previously presented in the 2013 consolidated financial statements within 'Net gains on financial instruments classified as held for trading'. This revision has been performed to enhance comparability with the current year presentation (see note 6).

Use of estimates and sources of uncertainty

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

During the year, the Group incorporated FVA into the fair value measurements of over-the-counter ("OTC") uncollateralised or partially collateralised derivatives, and in collateralised derivatives where the terms of the agreement do not permit the reuse of the collateral received.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

2. BASIS OF PREPARATION (CONTINUED)

Use of estimates and sources of uncertainty (continued)

For further details on the judgements used in determining fair value of certain assets and liabilities, see accounting policy note 3(d) and note 31.

For further details on the judgements used in determining whether the Group should consolidate a structured entity see note 15.

Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of the Company and its subsidiaries as at 31 December 2014. Subsidiaries are all entities over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The financial statements for the subsidiaries are prepared for the same reporting year as the Group, using consistent accounting policies. The financial statements of subsidiaries which have a non-US dollar reporting currency are translated into US dollars as described in note 3(b). Subsidiaries are consolidated from the date that the Group gains control until the date that control ceases.

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

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

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

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

Details of the Group's interests in other entities are given in note 15 to these financial statements.

The going concern assumption

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

2. BASIS OF PREPARATION (CONTINUED)

The going concern assumption (continued)

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

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Functional currency

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

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

b. Foreign currencies

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

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

c. Financial instruments

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

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

More information regarding these classifications is included below:

i) Financial instruments classified as held for trading

Purchases and sales of non-derivative financial instruments classified as held for trading are initially recognised on settlement date at fair value, including regular way securities transactions. For purchases of non-derivative financial instruments classified as held for trading, from the date that the terms are agreed (trade date) until the settlement date, the Group recognises any unrealised fair value in the consolidated statement of financial position as 'Financial instruments classified as held for trading' with corresponding profit or loss recognised within the consolidated income statement in 'Net gains/ (losses) on financial instruments classified as held for trading'.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

i) Financial instruments classified as held for trading (continued)

For sales of non-derivative financial instruments unrealised fair value changes are no longer recognised in the consolidated income statement from trade date. Upon settlement date the resulting financial instrument is recognised or de-recognised from the consolidated statement of financial position.

Derivatives are initially recognised on trade date at fair value. All subsequent changes in fair value are reflected in the consolidated income statement in 'Net gains/ (losses) on financial instruments classified as held for trading'.

All changes in fair value, foreign exchange differences, interest and dividends are reflected in the consolidated income statement in 'Net gains/ (losses) on financial instruments classified as held for trading'.

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

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

The Group has designated certain financial instruments at fair value through profit or loss when:

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

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

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

iii) Available-for-sale financial assets

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

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

For equity instruments, dividend income and impairment losses are recognised in the consolidated income statement in 'Net gains/ (losses) on available-for-sale financial assets'. All other gains and losses on equity instruments classified as available-for-sale are recognised in the 'Available-for-sale reserve' within equity.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

iv) Loans and receivables and financial liabilities at amortised cost

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

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

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

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

d. Fair value

Fair value measurement

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

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

The fair value of a financial instrument on initial recognition is the transaction price (i.e. the fair value of the consideration given or received).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Fair value measurement (continued)

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

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

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

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, for example, the type of product, whether the product is new and not yet established in the marketplace, the liquidity of markets and other characteristics particular to the product. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgement. Accordingly, the degree of judgement exercised by the Group in determining fair value is greatest for instruments categorised in Level 3 of the fair value hierarchy.

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Fair value measurement (continued)

During the year, the Group incorporated FVA into the fair value measurements of OTC uncollateralised or partially collateralised derivatives, and in collateralised derivatives where the terms of the agreement do not permit the re-use of the collateral received. The Group's implementation of FVA reflects the inclusion of FVA in the pricing and valuations by the majority of market participants involved in the Group's principal exit market for these instruments. In general, FVA reflects a market funding risk premium inherent in the noted derivative instruments. The implementation of FVA required a number of important management judgments including:

- Determining when sufficient market evidence exists to indicate that FVA should be incorporated into the fair value measurements;
- Estimating the fair value of funding costs and benefits in the principal exit market; and
- Determining the interaction between Credit Valuation Adjustment ("CVA") and FVA, given that CVA already reflects credit spreads, which are related to and can impact funding spreads.

The methodology for measuring FVA leverages the Group's existing credit-related valuation adjustment calculation methodologies, which apply to both assets and liabilities. The incorporation of FVA has resulted in an overall charge of \$273 million against aggregate revenues within 'Net gains on financial instruments classified as held for trading' in the consolidated income statement in 2014.

Valuation techniques

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

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

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

Credit valuation adjustments are applied to both short-term instruments and long-term borrowings (primarily structured notes) which are designated at fair value through profit or loss and to OTC derivatives. The impact of changes in own credit spreads based upon observations of secondary bond market spreads is considered when measuring the fair value for short-term and long-term borrowings. For OTC derivatives, the impact of changes in both the Group's and the counterparty's credit standing is considered when measuring fair value. In determining the expected exposure the Group simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party CDS spread data.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Valuation techniques (continued)

Where CDS spread data are unavailable for a specific counterparty, bond market spreads, credit CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. The Group also considers collateral held and legally enforceable master netting agreements that mitigate the Group's exposure to each counterparty.

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

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

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

Valuation process

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

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

- *Model Review.* VRG, in conjunction with the Market Risk Department and, where appropriate, the Credit Risk Management Department, both of which report to the Chief Risk Officer of the Morgan Stanley Group ("CRO"), independently review valuation models' theoretical soundness, the appropriateness of the valuation methodology and calibration techniques developed by the business units using observable inputs. Where inputs are not observable, VRG reviews the appropriateness of the proposed valuation methodology to ensure it is consistent with how a market participant would arrive at the unobservable input. The valuation methodologies utilised in the absence of observable inputs may include extrapolation techniques and the use of comparable observable inputs. As part of the review, VRG develops a methodology to independently verify the fair value generated by the business unit's valuation models. Before trades are executed using new valuation models, those models are required to be independently reviewed. All of the Group's valuation models are subject to an independent annual VRG review.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value (continued)

Valuation process (continued)

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

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

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

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

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

Gains and losses on inception

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

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

e. Derecognition of financial assets and liabilities

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

f. Impairment of financial assets

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

Impairment losses on available-for-sale financial assets are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value (see note 3(d) above). Where there is evidence that the available-for-sale financial asset is impaired, the cumulative loss that had been previously recognised in other comprehensive income is reclassified from the 'Available-for-sale reserve' and recognised in the consolidated income statement within 'Net gains/ (losses) on available-for-sale financial assets'.

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

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

g. Impairment of non-financial assets

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

h. Fees and commissions

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

i. Property, plant and equipment

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

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

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

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

j. Business combinations and disposals

i) Combination of businesses

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

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

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

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

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

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

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

j. Business combinations and disposals (continued)

i) Combination of businesses (continued)

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

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

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

ii) Combination of businesses under common control

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

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

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

iii) Disposal of subsidiaries

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

k. Cash and cash equivalents

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

l. Income tax

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

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

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

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

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

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

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

m. Operating leases

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

n. Provisions

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

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

o. Employee compensation plans

i) Equity-settled share-based compensation plans

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

ii) Other deferred compensation plans

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

p. Post-employment benefits

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

p. Post-employment benefits (continued)

For the Group's defined benefit post-employment plan, the plan obligations are measured on an actuarial basis in accordance with the advice of an independent qualified actuary using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the plan liabilities. Plan assets are measured at their fair value at the reporting date. A surplus or deficit of plan assets over liabilities is recognised in the consolidated statement of financial position as an asset or a liability respectively. If the fair value of the plan assets is higher than the present value of the defined benefit obligation, the measurement of the resulting defined benefit asset is limited to the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The current service cost and any past service costs together with the net interest on the net defined benefit obligation/ asset is charged to 'Staff costs' within 'Other expense' in the consolidated income statement. Remeasurements that arise in calculating the Group's obligation in respect of a plan are recognised in other comprehensive income, in the period in which they occur.

Details of the plans are given in note 35 to these consolidated financial statements.

q. Offsetting of financial assets and financial liabilities

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

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

	2014 \$millions	2013 \$millions
Net fair value gains reclassified from the available-for-sale reserve on disposal of assets	1	5

5. INTEREST INCOME AND INTEREST EXPENSE

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

In 2014, interest income and interest expense decreased by \$509 million and \$672 million respectively, from \$1,217 million and \$1,610 million respectively. A key driver of the decrease was a reduction in intercompany rebate rates on securities borrowed transactions.

No other gains or losses have been recognised in respect of loans and receivables other than as disclosed as 'Interest income' and as 'foreign exchange differences', 'impairment losses' and 'reversal of impairment losses' disclosed in 'Other expense' (note 7) within the consolidated income statement.

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

6. OTHER INCOME

	2014	Restated⁽¹⁾
	\$millions	2013
		\$millions
Fee and commission income:		
Advisory fees	454	233
Underwriting fees	810	801
Trust and other fiduciary activities	29	4
Non-UK capital gains tax recoverable	(105)	-
Other	67	166
	<u>1,255</u>	<u>1,204</u>

(1) Details of the restatement are provided in note 2.

Non-UK capital gains tax recoverable represents a reduction to the expected reimbursement from clients on certain equity transactions. Contractually the clients are legally bound to reimburse the Group for any tax, levy, duty, charge, assessment or fee, directly or indirectly, in connection with or arising from these equity transactions. The related reduction in tax expense incurred by the Group in relation to these equity transactions is reflected in 'Income tax expense' within the consolidated income statement (see note 8).

Other income for the year ended 31 December 2013 has been revised primarily to include underwriting fees. Underwriting fees were previously presented in the 2013 consolidated financial statements within "Net gains on financial instruments classified as held for trading". This revision has been performed to enhance comparability with the current year presentation.

7. OTHER EXPENSE

	2014	2013
	\$millions	\$millions
Direct staff costs	220	195
Management charges from other Morgan Stanley Group undertakings relating to staff costs	2,194	1,861
Management charges from other Morgan Stanley Group undertakings relating to other services	670	329
Brokerage fees	527	497
Administration and corporate services	343	362
Professional services	379	349
UK Bank levy	65	40
Operating lease rentals	7	9
Depreciation on property, plant and equipment	3	3
Impairment losses on loans and receivables (see note 9)	15	9
Reversal of impairment losses on loans and receivables (see note 9)	(5)	(12)
Net foreign exchange losses	2	13
Auditor's remuneration:		
Fees payable to the Company's auditor and its associates for the audit of the Company's annual financial statements	5	5
Fees payable to the Company's auditor and its associates for other services to the Group ⁽¹⁾	1	1
Other	132	247
	<u>4,558</u>	<u>3,908</u>

(1) Fees payable to the Company's auditor for other services in 2014 comprise other assurance services of \$556,000 (2013: \$553,000) and tax compliance services of \$44,000 (2013: \$233,000).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2014

7. OTHER EXPENSE (CONTINUED)

The Group incurs 'Direct staff costs' related mainly to staff employed by its branches and certain subsidiary undertakings. In addition, the Group utilises staff employed by other Morgan Stanley Group undertakings and incurs 'Management charges from other Morgan Stanley Group undertakings relating to staff costs'.

Included within both 'Direct staff costs' and 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' is an amount totalling \$205 million (2013: \$192 million) in relation to equity-settled share-based compensation plans, granted to employees of both the Group and the Morgan Stanley Group. These costs reflect the amortisation of equity-based awards granted to employees over the last three years and are therefore not directly aligned with other staff costs in the current year. Also included within 'Direct staff costs' and 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' are amounts totalling \$76 million (2013: \$68 million) in relation to pension plans (see note 35).

On 1 December 2014, the Compensation, Management Development and Succession ('CMDS') Committee of the Board of Directors of the Morgan Stanley Group approved an approach for awards of discretionary incentive compensation for the 2014 performance year to be granted in 2015 that would reduce the average deferral of such awards to an approximate baseline of 50%. Additionally, the CMDS Committee approved the acceleration of vesting for certain outstanding deferred cash-based incentive compensation awards. The deferred cash-based incentive compensation awards subject to accelerated vesting will be distributed on their regularly scheduled future distribution dates and will continue to be subject to cancellation and clawback provisions. This approach resulted in an increase in both 'Direct staff costs' and 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' for the year ended 31 December 2014.

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

	Number	
	Year ended 31 December 2014	Year ended 31 December 2013
Company and institutional securities infrastructure	137	139
Business units and other	163	167
	<u>300</u>	<u>306</u>
	2014	2013
	\$millions	\$millions
Wages and salaries	185	166
Social security costs	28	24
Pension costs	7	5
	<u>220</u>	<u>195</u>

The Group paid no remuneration to its Directors during the current or prior year but incurred management recharges in respect of Directors' qualifying services provided to the Group which are included within 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' within 'Other expense'. The amount of remuneration received by Directors in respect of their qualifying services to the Group is disclosed in note 36.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

8. INCOME TAX EXPENSE

	2014	2013
	\$millions	\$millions
Current tax expense		
United Kingdom corporation tax charge		
- current year	24	103
- adjustments in respect of prior years	(54)	(2)
Double taxation relief		
- current year	-	(81)
- adjustments in respect of prior years	29	1
Overseas tax		
- current year	119	128
- adjustments in respect of prior years	(105)	14
	<u>13</u>	<u>163</u>
Deferred tax expense/ (benefit)		
Origination and reversal of temporary differences	(1)	(41)
Adjustment in respect of prior years	23	3
Effect of changes in tax rates	1	11
	<u>23</u>	<u>(27)</u>
	<u>36</u>	<u>136</u>

Reconciliation of effective tax rate

The main differences between the Group's tax charge and the tax charge that would have been calculated from applying the average standard rate of corporation tax in the UK for the year of 21.49% (2013: 23.25%) are explained below:

	2014	2013
	\$millions	\$millions
(Loss)/profit before income tax	<u>(677)</u>	<u>173</u>
Income tax (credit)/ expense using the average standard rate of corporation tax in the UK of 21.49% (2013: 23.25%)	(145)	40
Impact on tax of:		
Expenses not deductible for tax purposes:		
UK bank levy	14	9
Other expenses	3	5
Carry forward of prior years tax losses	1	1
Group relief surrendered for no consideration	115	12
Net currency translation loss on disposal of subsidiaries	-	35
Effect of tax rates in foreign jurisdictions	10	16
Currency translation on tax	2	5
Tax exempt income	-	(1)
Tax under provided in prior years	6	2
(Reversal)/ recognition of tax reserves in respect of prior years	(13)	2
Other	43	10
Total income tax expense in the consolidated income statement	<u>36</u>	<u>136</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

8. INCOME TAX EXPENSE (CONTINUED)

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

Finance Act 2013 enacted a reduction to the UK corporation tax rate to 21% with effect from 1 April 2014. This reduction in the tax rate impacted the current tax charge in 2014. Finance Act 2013 also enacted a reduction to the UK corporation tax rate to 20% with effect from 1 April 2015. The reduction in the rate may impact the current tax charge in future years.

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

	2014			2013		
	Before tax \$millions	Tax (expense)/ benefit \$millions	Net of tax \$millions	Before tax \$millions	Tax (expense)/ benefit \$millions	Net of tax \$millions
Remeasurement of net defined benefit liability	2	-	2	2	-	2
Foreign currency translation reserve:						
Foreign currency translation differences on foreign operations	(60)	-	(60)	35	-	35
Reclassification of foreign currency translation differences on disposal of foreign operations	-	-	-	151	-	151
Available-for-sale reserve:						
Net change in fair value of available-for-sale financial assets	2	-	2	5	(1)	4
Reclassification adjustments relating to available-for-sale assets disposed of during the year	-	-	-	(5)	1	(4)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	-	(2)	(2)	-	(2)	(2)
Other comprehensive income/ (loss)	(56)	(2)	(58)	188	(2)	186

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

9. LOANS AND RECEIVABLES

	2014 \$millions	2013 \$millions
Loans and receivables	149,393	156,972
Less impairment losses	(46)	(45)
	<u>149,347</u>	<u>156,927</u>

A reconciliation of impairment losses for loans and receivables is as follows:

At 1 January	45	60
Charge for the year	15	9
Reversal of impairment losses	(5)	(12)
Amounts written off	(8)	(12)
Foreign exchange revaluation	(1)	-
At 31 December	<u>46</u>	<u>45</u>

10. OTHER RECEIVABLES

	2014 \$millions	2013 \$millions
Amounts held at exchanges	514	452
Amounts due from other Morgan Stanley Group undertakings	2,702	2,336
Other amounts receivable	101	177
	<u>3,317</u>	<u>2,965</u>

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

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

	2014		2013	
	Assets \$millions	Liabilities \$millions	Assets \$millions Restated ⁽¹⁾	Liabilities \$millions Restated ⁽¹⁾
Government debt securities	10,881	8,923	8,940	9,178
Corporate and other debt	11,251	2,219	11,872	2,741
Corporate equities	37,993	15,431	42,869	15,260
Derivatives	235,273	231,255	264,793	253,435
	<u>295,398</u>	<u>257,828</u>	<u>328,474</u>	<u>280,614</u>

(1) Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2014

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

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

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

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

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

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

	2014		2013	
	Assets \$millions	Liabilities \$millions	Assets \$millions	Liabilities \$millions
Prepaid OTC contracts	323	1,698	3,482	2,578
Corporate loans	1,296	-	1,882	-
Issued structured notes	-	1,449	-	1,150
Other financial assets and liabilities	1,741	1,984	2,309	9,395
	<u>3,360</u>	<u>5,131</u>	<u>7,673</u>	<u>13,123</u>

The maximum exposure to credit risk of loans or receivables which are designated at fair value through profit or loss as at 31 December 2014 is \$1,296 million (2013: \$1,882 million). The cumulative change in fair value of such loans or receivables attributable to changes in credit risk amounts to a gain of \$1 million (2013: loss of \$4 million) and the change for the current year is a gain of \$5 million (2013: gain of \$nil). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2014

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

The change in fair value recognised through the consolidated income statement attributable to own credit risk for financial liabilities designated at fair value during the year is a gain of \$31 million (2013: loss of \$50 million) and cumulatively is a gain of \$43 million (2013: gain of \$12 million). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk.

The carrying amount of financial liabilities designated at fair value was \$45 million lower than the contractual amount due at maturity (2013: \$77 million higher).

13. AVAILABLE-FOR-SALE FINANCIAL ASSETS

Financial assets that are classified as available-for-sale consist of corporate equities, of which \$2 million are listed investments (2013: \$2 million).

Movement in available-for-sale financial assets

	2014	2013
	\$millions	\$millions
Fair value		
At 1 January	60	40
Additions	-	27
Changes in fair value recognised in the available-for-sale reserve	(4)	5
Disposals and other settlements	(14)	(12)
At 31 December	<u>42</u>	<u>60</u>

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

14. INTERESTS IN SUBSIDIARIES

Composition of the Group

The Group consists of a parent company, Morgan Stanley & Co. International plc (“MSIP”) and a number of subsidiaries, held directly and indirectly by MSIP which operate and are incorporated around the world.

Details of the principal investments in subsidiaries of the Company at 31 December 2014 and at 31 December 2013, listed alphabetically by country are as follows:

Name of Company	Country of incorporation	Type of shares held	Proportion of shares held by the Group ⁽¹⁾	Nature of business
Morgan Stanley Equity Investments (UK) Limited	Cayman Islands	Ordinary	100%	Financial services
Morgan Stanley (France) SAS	France	Ordinary	100%	Financial services
Morgan Stanley Equity Derivative Services (Luxembourg) S.ar.l	Luxembourg	Ordinary	100%	Financial services
Morgan Stanley Equity Holding (Netherlands) B.V.	Netherlands	Ordinary	100%	Financial services
Morgan Stanley Taiwan Limited	Republic of Taiwan	Ordinary	100%	Financial services
Morgan Stanley Equity Trading (DIFC) Limited	United Arab Emirates	Ordinary	100%	Financial services
Morgan Stanley Equity Financing Limited	United Kingdom	Ordinary	100%	Financial services
Rolympus (UK) Commodities Group Limited ⁽²⁾	United Kingdom	Ordinary	100%	Financial services
Cabot 38 Limited	United Kingdom	Ordinary	100%	Financial services

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

(2) Rolympus (UK) Commodities Group Limited was established in 2014.

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

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

Except as disclosed below in “Disposal of subsidiaries”, there were no changes in the Group’s ownership interests in subsidiaries during 2014 (2013: none).

Information regarding interests in structured entities is included in note 15.

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

14. INTERESTS IN SUBSIDIARIES (CONTINUED)

Disposal of subsidiaries

During 2014, the Group disposed of two wholly owned subsidiaries, Morgan Stanley Cadzand III and Morgan Stanley Bramley Investments Limited to another Morgan Stanley Group undertaking. The subsidiaries were sold for consideration equal to their net book values, both of which were \$0.1 million, resulting in no gain or loss being recognised in the consolidated income statement as a result of these sales.

In 2013, the Group disposed of six 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 consolidated income statement within “Net currency translation loss on disposal of subsidiaries”. This reclassification did not have an impact on the net assets of the Group.

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

	2014	2013
	At disposal	At disposal
	\$millions	\$millions
ASSETS		
Trade receivables	-	1,899
Financial assets classified as held for trading	-	1,840
TOTAL ASSETS	<u>-</u>	<u>3,739</u>
LIABILITIES		
Other payables	-	1,901
Financial liabilities classified as held for trading	-	3
TOTAL LIABILITIES	<u>-</u>	<u>1,904</u>
NET ASSETS	<u>-</u>	<u>1,835</u>
Total consideration received	-	1,835
Reclassification of net cumulative translation losses	-	151
Loss on disposal	<u>-</u>	<u>151</u>
Total consideration received in cash	-	1,835
Less cash and cash equivalents in subsidiary disposed of	-	-
Net cash inflows arising on disposal	<u>-</u>	<u>1,835</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

15. INTERESTS IN STRUCTURED ENTITIES

The Group is involved with various special purpose entities 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

15. 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 consolidated statement of financial position.

The usage of structured entities is described below.

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

Credit Protection Purchased through CLNs. In a CLN transaction, the Group transfers reference assets (generally high-quality securities or money market investments) to a structured entity, enters into a derivative transaction in which the structured entity writes protection on an unrelated reference asset or group of assets, through a credit default swap, a total return swap or similar instrument, and sells to investors the securities issued by the structured entity. In some transactions, the Group may also enter into interest rate or currency swaps with the structured entity. The purchase of the transferred assets by the structured entity is financed through the sale of the securities issued. Upon the occurrence of a credit event related to the reference asset, the structured entity will deliver collateral securities as the payment to the Group. The Group is generally exposed to price changes on the collateral securities in the event of a credit event and subsequent sale. These transactions are designed to provide investors with exposure to certain credit risk on the reference asset. The structure of the transaction determines the accounting treatment. In some transactions, the assets and liabilities of the structured entity are recognised in the Group's consolidated financial statements. In other transactions, the transfer of the collateral securities is accounted for as a sale of assets, and the structured entity is not consolidated. CLNs are included in Other in the tables below.

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

15. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

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

Consolidated structured entities

As at 31 December 2014 the Group did not have any structured entities that it consolidated. The table below shows information about the structured entities the Group consolidated 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 financial statements, net of losses absorbed by third-party holders of the structured entity's liabilities. The Group had no additional maximum exposure to losses at 31 December 2013.

The Group has not provided financial support to, 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 shows certain non-consolidated structured entities in which the Group had an interest at 31 December 2014 and at 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

15. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Unconsolidated structured entities (continued)

	Mortgage and asset-backed securitisations \$millions	Collateralised debt obligations \$millions	Fund investments \$millions	Other \$millions	Total \$millions
31 December 2014					
Structured entity assets that the Group does not consolidate (unpaid principal balance)	18,375	4,106	2,576	95	25,152
Maximum exposure to loss:					
Debt and equity interests	922	124	-	16	1,062
Derivative and other contracts	-	-	2,576	35	2,611
Total maximum exposure to loss	922	124	2,576	51	3,673
Carrying value of exposure to loss - assets ⁽¹⁾ :					
Debt and equity interests	922	124	-	16	1,062
Derivative and other contracts	-	-	-	-	-
Total carrying value of exposure to loss - assets	922	124	-	16	1,062
Carrying value of exposure to loss - liabilities ⁽¹⁾ :					
Derivative and other contracts	-	-	13	2	15
Total carrying value of exposure to loss - liabilities	-	-	13	2	15

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

15. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

	Mortgage and asset-back securitisations \$millions	Collateralised debt obligations \$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 ⁽¹⁾ :					
Debt and equity interests	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 ⁽¹⁾ :					
Derivative and other contracts	-	-	6	1	7
Total carrying value of exposure to loss - liabilities	-	-	6	1	7

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

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

15. INTERESTS IN STRUCTURED ENTITIES (CONTINUED)

Securitisation transactions generally involve structured entities. Primarily as a result of its secondary market-making activities, the Group owned additional securities issued by securitisation structured entities for which the maximum exposure to loss is less than specific thresholds. These additional securities totalled \$513 million at 31 December 2014 (2013: \$542 million). These securities were retained in connection with transfers of assets by the Group. Securities issued by securitisation structured entities consist of \$262 million of securities backed primarily by residential mortgage loans (2013: \$244 million), \$86 million of securities backed by commercial mortgage loans (2013: \$160 million), \$100 million of securities backed by collateralised debt obligations or collateralised loan obligations (2013: \$137 million) and \$65 million backed by other consumer loans (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 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 financial support to, 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 the Group's name is associated with the structured entity or where market participants may generally expect the Group to be associated with the structured entity.

For some sponsored entities, the Group has no interest at 31 December 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 2014 was \$0.7 million (2013: loss of \$76 million). Losses are reported under 'Net gains on financial instruments classified as held for trading' in the consolidated income statement. During the current and prior years, no assets were transferred to the sponsored entities.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

16. PROPERTY, PLANT AND EQUIPMENT

2014

	Leasehold improvements \$millions	Fixtures, fittings and equipment \$millions	Total \$millions
Cost			
At 1 January 2014	25	23	48
Additions	1	1	2
Foreign exchange revaluation	(2)	(2)	(4)
Disposals	(3)	(1)	(4)
At 31 December 2014	<u>21</u>	<u>21</u>	<u>42</u>
Depreciation			
At 1 January 2014	23	20	43
Charge for the year	2	1	3
Foreign exchange revaluation	(2)	(2)	(4)
Disposals	(3)	(1)	(4)
At 31 December 2014	<u>20</u>	<u>18</u>	<u>38</u>
Carrying amount			
At 31 December 2014	<u>1</u>	<u>3</u>	<u>4</u>

2013

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

17. SUBORDINATED LOANS

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

Counterparty	Repayment Date	Interest Rate	2014 \$millions	2013 \$millions
Morgan Stanley UK Financing I LP	31 October 2025	3 months LIBOR ⁽¹⁾ plus 1.475%	7,906	7,906

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

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

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

18. OTHER PAYABLES

	2014 \$millions	2013 \$millions
Amounts due to other Morgan Stanley Group undertakings	13,870	15,807
Other amounts payable	264	2,372
	<u>14,134</u>	<u>18,179</u>

19. PROVISIONS

	Property \$millions	Litigation \$millions	Other \$millions	Total \$millions
At 1 January 2014	4	1	25	30
Additional provisions	2	1	12	15
Provisions utilised	-	(1)	-	(1)
Foreign exchange revaluation	(1)	-	-	(1)
At 31 December 2014	<u>5</u>	<u>1</u>	<u>37</u>	<u>43</u>

Property

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Property, plant and equipment' (note 16).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

19. PROVISIONS (CONTINUED)

Litigation matters

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

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

The Group contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the 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. The Group cannot predict with certainty if, how or when such proceedings or investigations will be resolved or what the eventual settlement, fine, penalty or other relief, if any, may be, particularly for proceedings and investigations where the factual record is being developed or contested or where plaintiffs or government entities seek substantial or indeterminate damages, restitution, disgorgement or penalties. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages or other relief, and by addressing novel or unsettled legal questions relevant to the proceedings or investigations in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for a proceeding or investigation. Subject to the foregoing, the Group believes, based on current knowledge and after consultation with counsel, that the outcome of such proceedings and investigations will not have a material adverse effect on the consolidated financial position of the Group, although the outcome of such proceedings or investigations could be material to the Group's operating results and cash flows for a particular period depending on, among other things, the level of the Group's revenues or income for such period.

Over the last several years, the level of litigation and investigatory activity (both formal and informal) by government and 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 certain proceedings that the Group believes to be material, individually or collectively, there can be no assurance that additional material losses will not be incurred from claims that have not yet been asserted or are not yet determined to be material.

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Group and another Morgan Stanley Group undertaking, styled *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al.*, which is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a \$275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Group and another Morgan Stanley Group undertaking misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Group and another

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

19. PROVISIONS (CONTINUED)

Litigation matters (continued)

Morgan Stanley Group undertaking knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately \$228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional \$12 million, punitive damages, equitable relief, fees and costs. On 28 February 2011, the court denied the Group's and another Morgan Stanley Group undertaking's motion to dismiss the complaint.

On 1 July 2013, the European Commission ("EC") issued a Statement of Objections ("SO") addressed to twelve financial firms (including the Group), the International Swaps and Derivatives Association, Inc. and Markit Group Limited and various other Morgan Stanley Group undertakings alleging that, between 2006 and 2009, the recipients breached EU competition law by taking and refusing to take certain actions in an effort to prevent the development of exchange traded CDS products. The SO indicates that the EC plans to impose remedial measures and fines on the recipients. The Group, other Morgan Stanley Group undertakings and the other recipients filed a response to the SO on 21 January 2014, and attended oral hearings before the EC during the period 12 to 19 May 2014. The Group's and the other Morgan Stanley Group undertakings' oral hearing took place on 15 May 2014. The Group and the other Morgan Stanley Group undertakings filed a supplemental response to the SO on 11 July 2014. A Morgan Stanley Group undertaking and others have also responded to an investigation by the Antitrust Division of the United States Department of Justice related to the CDS market.

On 8 May 2014, the California Attorney General's Office ("CAAG"), which is one of the members of the Residential Mortgage-Backed Securities ("RMBS") Working Group, indicated that it has made certain preliminary conclusions that the Morgan Stanley Group made knowing and material misrepresentations regarding RMBS and that it 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.

Other

Provisions have been raised in relation to certain matters that the Group may be required to settle on behalf of clients or in relation to its own account. The amount of these provisions reflect the most likely estimate within an identified range of possible outcomes.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

20. DEFERRED TAX ASSETS AND LIABILITIES

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

	2014		2013	
	Deferred tax asset \$millions	Deferred tax liability \$millions	Deferred tax asset \$millions	Deferred tax liability \$millions
At 1 January	115	(3)	91	(4)
Amount recognised in the consolidated income statement	(24)	1	37	1
Amount recognised in other comprehensive income	(2)	1	(2)	-
Impact of changes in tax rates recognised in the consolidated income statement	(1)	-	(11)	-
Impact of changes in tax rates recognised in other comprehensive income	-	-	(1)	-
Foreign exchange adjustment	(2)	-	1	-
At 31 December	86	(1)	115	(3)

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

	Deferred tax asset 2014 \$millions	Deferred tax liability 2014 \$millions	Consolidated income statement 2014 \$millions	Deferred tax asset 2013 \$millions	Deferred tax liability 2013 \$millions	Consolidated income statement 2013 \$millions
Depreciation - temporary differences	5	-	-	4	-	-
Deferred compensation	17	-	4	23	-	2
Available-for-sale financial assets	-	-	-	-	(1)	-
Tax losses carried forward	6	-	11	22	-	(22)
Forecast currency hedges	-	(1)	(1)	-	(2)	(1)
Amounts not recognised due to unobservable market data	3	-	-	5	-	-
Deferred interest	54	-	5	56	-	4
Other temporary differences	1	-	4	5	-	(10)
	86	(1)	23	115	(3)	(27)

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

20. DEFERRED TAX ASSETS AND LIABILITIES (CONTINUED)

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

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

	2014 \$millions	2013 \$millions
Unused tax losses	8	8

The aggregate amount of temporary differences associated with investments in subsidiaries and branches for which deferred tax liabilities have not been recognised is \$nil (2013: \$nil).

21. COMMITMENTS AND CONTINGENCIES

Leases

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

	2014 \$millions	2013 \$millions
Lease payments under non-cancellable operating leases recognised as an expense in the year		
- Minimum lease payments	7	9

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

	2014 \$millions	2013 \$millions
Within one year	7	8
In the second to fifth years inclusive	22	21
After five years	5	9
	34	38

Contingent liability relating to tax

The tax position of a subsidiary undertaking of the Group is currently under review by the Dutch tax authorities. The review has not progressed sufficiently to determine the timings of resolution or the amount of any outflow. The current estimate of the maximum amount payable, if any, arising from this review is \$150 million.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

21. COMMITMENTS AND CONTINGENCIES (CONTINUED)

Other commitments and contingent liabilities

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

<i>Contingent liabilities</i>	2014	2013
	\$millions	\$millions
Contingent commitments	962	821
Letters of credit	1	1
	<u>963</u>	<u>822</u>
	<u>963</u>	<u>822</u>
 <i>Commitments</i>	 2014	 2013
	\$millions	\$millions
Loan commitments	1,815	1,870
Underwriting commitments	290	588
Forward starting reverse repurchase agreements ⁽¹⁾⁽²⁾	24,797	23,857
	<u>26,902</u>	<u>26,315</u>
	<u>26,902</u>	<u>26,315</u>

(1) Forward starting reverse repurchase agreement commitments represent the value of unsettled securities purchased under agreements to resell, which have a trade date at or prior to 31 December 2014 and settle subsequent to period end.

(2) The presentation of 'forward starting reverse repurchase agreements' for the year ended 31 December 2013 has been revised. 'Forward starting reverse repurchase agreements' were previously presented as 'contingencies' in the 2013 consolidated financial statements. This revision has been performed for consistency with the current year presentation.

22. EQUITY

	Ordinary shares of \$1 each \$millions	Ordinary shares of £1 each \$millions	Class A ordinary shares of \$1 each \$millions	Additional Tier 1 capital \$millions	Class C, non- cumulative, preference shares of \$1 each \$millions	Class D1, non- cumulative, preference shares of \$0.4 each \$millions	Total equity instruments \$millions
Issued and fully paid:							
At 1 January 2013	6,884	30	1,500	-	50	1,000	9,464
Issued / (repurchased) in the year:							
Ordinary shares of \$1 each issued	3,050	-	-	-	-	-	3,050
Non-cumulative, preference shares repurchased	-	-	-	-	(50)	(1,000)	(1,050)
At 31 December 2013	<u>9,934</u>	<u>30</u>	<u>1,500</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>11,464</u>
At 1 January 2014	9,934	30	1,500	-	-	-	11,464
Issued in the year:							
Additional Tier 1 capital	-	-	-	1,300	-	-	1,300
At 31 December 2014	<u>9,934</u>	<u>30</u>	<u>1,500</u>	<u>1,300</u>	<u>-</u>	<u>-</u>	<u>12,764</u>
Voting rights at 31 December 2014	<u>99.7% ⁽¹⁾</u>	<u>0.3% ⁽¹⁾</u>	<u>Non-voting</u>	<u>Non-voting</u>	<u>-</u>	<u>-</u>	<u>100%</u>

(1) Ordinary shares are pari passu with each other regardless of currency and together carry 100% of the vote (2013: 100%)

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

22. EQUITY (CONTINUED)

Additional Tier 1 capital

On 15 December 2014, the Company issued Additional Tier 1 capital instruments (the “Instruments”) with a value of \$1,300 million to Morgan Stanley UK Group, a UK incorporated indirect parent of the Company. The Instruments include a trigger mechanism whereby if the Common Equity Tier 1 capital ratio of the Company falls below a pre-determined level, the Company will write-down the outstanding principal amount of the Instruments, together with any accrued but interest coupon. In this situation, Morgan Stanley UK Group would have no further rights against the Company in respect of the instruments. The Instruments have no defined maturity, are callable at the Company’s discretion after five years from their date of issuance and are subordinated to senior creditors and subordinated loan creditors of the Company. The Instruments are not entitled to any participation in the residual net assets of the Company. Coupons on the Instruments are non-cumulative and payable at a fixed rate of 8.75% per annum for five years, resettable every five years thereafter. Payment of the coupon is wholly at the discretion of the Company.

A payment of coupon interest was approved by the Board of Directors on 22 January 2015 (see note 23).

On 24 March 2015, the terms of the Instruments were amended to remove the reset feature and revise the rate payable to a fixed rate of 9% per annum. All other terms remain unchanged.

Equity instruments

At 31 December 2014 the total equity instruments in issue of the Company equated to \$12,764 million (2013: \$11,464 million) comprising 9,934,105,148 (2013: 9,934,105,148) ordinary shares of \$1 each, 17,615,107 (2013: 17,615,107) ordinary shares of £1 each, 1,500,000,000 (2013: 1,500,000,000) Class A Non-voting ordinary shares of \$1 each and Additional Tier 1 capital instruments of \$1,300,000,000 (2013: \$nil). All equity instruments are fully paid.

On 20 January 2015 1,000,000 ordinary shares of \$1 each were issued at par, to the Company’s immediate parent undertaking for cash consideration.

The holders of the ordinary shares are entitled to receive dividends as declared from time to time and are entitled, on a show of hands, to one vote and, on a poll, one vote per share at meetings of the shareholders of the Company. All shares rank equally with regard to the Company’s residual net assets.

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

Reserves

Share premium

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

Currency translation reserve

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

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

In 2013, the Group disposed of six wholly owned subsidiaries, which were non-US dollar functional entities, to other Morgan Stanley Group undertakings. A consequence of these disposals was that accumulated foreign exchange losses totalling \$151 million were reclassified from the ‘currency translation reserve’ to the consolidated income statement.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

22. EQUITY (CONTINUED)

Reserves (continued)

Available-for-sale reserve

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

Capital contribution reserve

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

Capital redemption reserve

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

Pension reserve

The 'Pension reserve' comprises cumulative actuarial gains or losses on scheme assets and obligations net of current tax and the impact of the asset surplus ceiling (see note 35).

23. DIVIDENDS

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

	2014		2013	
	Per share \$	Total \$millions	Per share \$	Total \$millions
Dividends on Class C preference shares	-	-	0.020	1
Dividends on Class D1 preference shares	-	-	0.035	88
		<u>-</u>		<u>89</u>

The Class C preference share dividend was paid in December 2013 and the Class D1 preference share dividend was paid in January 2014 although this dividend was declared and therefore accrued as at 31 December 2013.

On 22 January 2015, the Directors approved a coupon payment on the Additional tier 1 capital instruments of \$14,850,694 out of reserves available for distribution at 31 December 2014 (2013: \$nil). This payment was made on 30 January 2015. The payment has not been accrued in the consolidated financial statements for the year ended 31 December 2014 as it was not due at that date.

The Directors have not proposed the payment of a final dividend out of reserves available at 31 December 2014 (2013: \$nil).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

24. ADDITIONAL CASH FLOW INFORMATION

a. Cash and cash equivalents

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

	2014	2013
	\$millions	\$millions
Cash and short-term deposits	11,671	12,244
Bank loans and overdrafts	(15)	(16)
	<u>11,656</u>	<u>12,228</u>

Included within 'Cash and short term deposits' is \$8,384 million (2013: \$8,267 million) of segregated client money, held in accordance with the FCA's Client Money Rules, and an amount of \$747 million (2013: \$386 million) which represents other client money, that is not available for use by the Group. The corresponding payable is recognised and included in 'Trade payables' within 'Financial liabilities at amortised cost'.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

24. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)

b. Reconciliation of cash flows from operating activities

	Note	2014 \$millions	2013 \$millions
(Loss)/profit for the year		(713)	37
<i>Adjustments for:</i>			
Net gains on available-for-sale financial assets	4	(1)	(5)
Depreciation on property, plant and equipment	16	3	3
Movement in impairment losses for loans and receivables	9	10	-
Interest income		(708)	(1,217)
Interest expense		938	1,610
Income tax expense	8	36	136
Net currency translation loss on disposal of subsidiaries	14	-	151
Operating cash flows before changes in operating assets and liabilities		<u>(435)</u>	<u>715</u>
Changes in operating assets			
Decrease in loans and receivables, excluding cash and short term deposits (restated) ⁽¹⁾		6,956	25,052
Decrease in financial assets classified as held for trading (restated) ⁽¹⁾		33,076	11,075
Decrease/(increase) in financial assets designated at fair value through profit or loss		<u>4,313</u>	<u>(82)</u>
		<u>44,345</u>	<u>36,045</u>
Changes in operating liabilities			
Decrease in financial liabilities at amortised cost, excluding bank loans and overdrafts (restated) ⁽¹⁾		(14,506)	(8,603)
Decrease in financial liabilities classified as held for trading (restated) ⁽¹⁾		(22,786)	(31,068)
(Decrease)/increase in financial liabilities designated at fair value through profit or loss		(7,992)	563
Increase/ (decrease) in provisions		<u>13</u>	<u>(53)</u>
		<u>(45,271)</u>	<u>(39,161)</u>
Interest received		720	1,348
Interest paid		(830)	(1,770)
Income taxes paid		(136)	(183)
Effect of foreign exchange movements		29	(20)
Net cash flows used in operating activities		<u><u>(1,578)</u></u>	<u><u>(3,026)</u></u>

(1) Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

25. EXPECTED MATURITY OF ASSETS AND LIABILITIES

The tables below shows an analysis of assets and liabilities analysed according to when they are expected to be recovered, realised or settled.

At 31 December 2014

	Less than or equal to twelve months \$millions	More than twelve months \$millions	Total \$millions
ASSETS			
Loans and receivables:			
Cash and short term deposits	11,671	-	11,671
Cash collateral on securities borrowed	20,691	-	20,691
Securities purchased under agreements to resell	58,724	-	58,724
Trade receivables	54,944	-	54,944
Other receivables	2,803	514	3,317
	<u>148,833</u>	<u>514</u>	<u>149,347</u>
Financial assets classified as held for trading	295,398	-	295,398
Financial assets designated at fair value through profit or loss	2,589	771	3,360
Available-for-sale financial assets	-	42	42
Current tax assets	217	-	217
Deferred tax assets	-	86	86
Prepayments and accrued income	72	-	72
Property, plant and equipment	-	4	4
	<u>447,109</u>	<u>1,417</u>	<u>448,526</u>
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	15	-	15
Cash collateral on securities loaned	17,499	-	17,499
Securities sold under agreements to repurchase	42,844	3,067	45,911
Trade payables	83,561	-	83,561
Subordinated loans	-	7,906	7,906
Other payables	10,968	3,166	14,134
	<u>154,887</u>	<u>14,139</u>	<u>169,026</u>
Financial liabilities classified as held for trading	257,828	-	257,828
Financial liabilities designated at fair value through profit or loss	3,269	1,862	5,131
Provisions	-	43	43
Current tax liabilities	105	-	105
Deferred tax liabilities	-	1	1
Accruals and deferred income	199	-	199
Post-employment benefit obligations	-	5	5
	<u>416,288</u>	<u>16,050</u>	<u>432,338</u>

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

25. EXPECTED MATURITY OF ASSETS AND LIABILITIES (CONTINUED)

At 31 December 2013	Less than or equal to twelve months \$millions	More than twelve months \$millions	Total \$millions
ASSETS			
Loans and receivables:			
Cash and short term deposits	12,244	-	12,244
Cash collateral on securities borrowed	17,372	-	17,372
Securities purchased under agreements to resell	75,697	20	75,717
Trade receivables (restated) ⁽¹⁾	48,629	-	48,629
Other receivables	2,513	452	2,965
	<u>156,455</u>	<u>472</u>	<u>156,927</u>
Financial assets classified as held for trading (restated) ⁽¹⁾	328,474	-	328,474
Financial assets designated at fair value through profit or loss	7,439	234	7,673
Available-for-sale financial assets	-	60	60
Current tax assets	229	-	229
Deferred tax assets	-	115	115
Prepayments and accrued income	43	-	43
Property, plant and equipment	-	5	5
	<u>492,640</u>	<u>886</u>	<u>493,526</u>
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	16	-	16
Cash collateral on securities loaned	13,457	-	13,457
Securities sold under agreements to repurchase	67,870	2,146	70,016
Trade payables (restated) ⁽¹⁾	74,056	-	74,056
Subordinated loans	-	7,906	7,906
Other payables	14,978	3,201	18,179
	<u>170,377</u>	<u>13,253</u>	<u>183,630</u>
Financial liabilities classified as held for trading (restated) ⁽¹⁾	280,614	-	280,614
Financial liabilities designated at fair value through profit or loss	10,095	3,028	13,123
Provisions	27	3	30
Current tax liabilities	242	-	242
Deferred tax liabilities	-	3	3
Accruals and deferred income	221	-	221
Post-employment benefit obligations	-	4	4
	<u>461,576</u>	<u>16,291</u>	<u>477,867</u>

(1) Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

26. SEGMENT REPORTING

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

Business segments

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

The Group has one reportable business segment, Institutional Securities, which provides financial advisory and capital raising services; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities. Investment Management was not disclosed as a reportable business segment in 2014 as it did not meet the quantitative thresholds defined under accounting standards that requires it to be reported as a separate business segment.

In 2013, the Group had two reportable business segments, being Institutional Securities and Investment Management. Investment Management provides a broad array of investment strategies that span the risk/return spectrum across geographies, asset classes and public and private markets to a diverse group of clients across the institutional and intermediary channels as well as high net worth clients.

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

2013	Institutional securities \$millions	Investment management \$millions	Total \$millions
Consolidated income statement information:			
Net gains on financial instruments classified as held for trading (restated) ⁽¹⁾	3,281	-	3,281
Net gains on financial instruments designated at fair value through profit or loss	135	-	135
Net gains on available-for-sale financial assets	5	-	5
Net interest	(393)	-	(393)
Other income (restated) ⁽¹⁾	1,175	29	1,204
External revenues net of interest	4,203	29	4,232
Other expense	(3,853)	(55)	(3,908)
Loss on disposal of subsidiaries	(151)	-	(151)
Profit/ (loss) before income tax	199	(26)	173
Income tax (expense)/ credit	(142)	6	(136)
Profit/ (loss) for the year	57	(20)	37
Consolidated statement of financial position information:			
Segment assets (restated) ⁽¹⁾	493,519	7	493,526
Segment liabilities (restated) ⁽¹⁾	477,860	7	477,867
Other segment information:			
Capital expenditure	1	-	1
Depreciation and amortisation	3	-	3
Impairment loss on financial assets	9	-	9

(1) Details of the restatement are provided in note 2.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

26. SEGMENT REPORTING (CONTINUED)

Geographical segments

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

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

	EMEA		Americas		Asia		Total	
	2014	2013	2014	2013	2014	2013	2014	2013
	\$millions							
External revenues net of interest	3,850	4,093	21	23	10	116	3,881	4,232
(Loss) / profit before income tax	(599)	157	(18)	(25)	(60)	41	(677)	173
Total assets (restated) ⁽¹⁾	306,460	397,121	89,042	49,926	53,024	46,479	448,526	493,526

(1) Details of the restatement are provided in note 2.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. 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 includes 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. Credit risk includes the risk that economic, social and political conditions and events in a foreign country will adversely affect an obligor's ability and willingness to fulfill their obligations.

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

The Group may incur credit risk in its Institutional Securities business segment through a variety of activities, including, but not limited to, the following:

- 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 or long-term funding that is secured by physical or financial collateral whose value may at times be insufficient to fully cover the loan repayment amount;
- posting margin and / or collateral to clearing houses, clearing agencies, exchanges, banks, securities firms and other financial counterparties;
- placing funds on deposit at other financial institutions to support the Group's clearing and settlement obligations; 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.

Monitoring and control

In order to help protect the Group from losses, the Group's Credit Risk Management Department establishes firm-wide practices to evaluate, monitor and control credit risk exposure at the transaction, obligor and portfolio levels. The Group's 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, credit risk exposure is actively managed by credit professionals and committees within the Group's Credit Risk Management Department and through various risk committees, whose membership includes individuals from the Group's Credit Risk Management Department. A comprehensive and global Credit Limits Framework is utilised to manage credit risk levels across the Group. The Credit Limits Framework is calibrated within the Group's risk tolerance and includes single-name limits and portfolio concentration limits by country, industry and product type.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Monitoring and control (continued)

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, credit spreads), risk parameters (e.g., default probabilities and loss given default), recovery rates and expected losses in order to assess the impact of stresses on exposures, profit and loss and the Company's capital position. 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.

Credit Evaluation. The evaluation of corporate and institutional counterparties includes assigning obligor credit ratings, which reflect an assessment of an obligor's probability of default and loss given default. Credit evaluations typically involve the assessment of financial statements, leverage, liquidity, capital strength, asset composition and quality, market capitalisation, access to capital markets, the adequacy of collateral, if applicable, and in the case of certain loans, cash flow projections and debt service requirements. The Group's Credit Risk Management Department also evaluates strategy, market position, industry dynamics, management and other factors that could affect the obligor's risk profile. Additionally, the Group's Credit Risk Management Department evaluates the relative position of the Group's exposure in the borrower's capital structure and relative recovery prospects, as well as adequacy of collateral (if applicable) and other structural elements of the particular transaction.

In addition to assessing and monitoring its credit exposure and risk at the individual obligor level, the Group also reviews its credit exposure and risk to geographic regions. As at 31 December 2014, credit exposure was concentrated in Western Europe and Asia. In addition, the Group pays particular attention to smaller exposures in emerging markets given their unique risk profile. Country ceiling ratings are derived using methodologies generally consistent with those employed by external rating agencies.

The Group also reviews its credit exposure and risk to types of customers. At 31 December 2014, the Group's material credit exposure was to corporate entities, sovereign-related entities and financial institutions.

Risk Mitigation. The Credit Risk Management Department may seek to mitigate credit risk from its lending and trading activities in multiple ways, including collateral provisions, guarantees and hedges. At the transaction level, the Credit Risk Management Department seeks to mitigate risk through management of key risk elements such as size, tenor, financial covenants, seniority and collateral. The Group actively hedges its lending and derivatives exposure through various financial instruments that may include single-name, portfolio and structured credit derivatives. Additionally, the Group may sell, assign or syndicate funded loans and lending commitments to other financial institutions in the primary and secondary loan market. In connection with its derivatives trading activities, the Group generally enters into master netting agreements and collateral arrangements with counterparties. These agreements 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 agreement in the event of a counterparty default.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Monitoring and control (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 counterparties. 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 31 December 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 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. Where the Group enters into credit enhancements, including receiving cash and securities 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 CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class:

Class	2014			2013		
	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	11,671	-	11,671	12,244	-	12,244
Cash collateral on securities borrowed	20,691	(19,770)	921	17,372	(16,810)	562
Securities purchased under agreements to resell	58,724	(57,640)	1,084	75,717	(73,030)	2,687
Trade receivables ⁽³⁾	54,944	-	54,944	47,848	-	47,848
Other receivables	2,702	-	2,702	2,336	-	2,336
Financial assets classified as held for trading:						
Derivatives	235,273	(224,980)	10,293	264,793	(252,050)	12,743
Financial assets designated at fair value through profit or loss	3,360	(1,760)	1,600	7,673	(5,643)	2,030
	387,365	(304,150)	83,215	427,983	(347,533)	80,450
Unrecognised financial instruments						
Contingent commitments	962	-	962	821	-	821
Letters of credit	1	-	1	1	-	1
Loan commitments	1,815	-	1,815	1,870	-	1,870
Underwriting commitments	290	-	290	588	-	588
Unsettled securities purchased under agreements to resell ⁽⁴⁾	24,797	-	24,797	23,857	-	23,857
	415,230	(304,150)	111,080	455,120	(347,533)	107,587

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

(2) Of the residual net credit exposure, intercompany cross product netting arrangements are in place which would allow for an additional \$2,928 million (2013: \$2,977 million) to be offset in the event of default by certain Morgan Stanley counterparties.

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

(4) For unsettled securities purchased under agreement to resell, 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 further disclosed in note 30.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

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

Credit rating:	Gross credit exposure	
	2014 \$millions	2013 \$millions
AAA	14,895	12,572
AA	72,747	97,249
A	246,673	259,253
BBB	54,410	52,084
BB	15,736	17,344
B	3,849	7,113
CCC	2,671	3,889
Unrated	4,249	5,616
	<u>415,230</u>	<u>455,120</u>

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

Financial assets past due but not impaired:

At 31 December 2014, \$38 million of financial assets included in trade receivables in the consolidated statement of financial position were past due but not impaired. At 31 December 2013 there were no financial assets past due but not impaired.

Financial assets individually impaired:

	2014 \$millions	2013 \$millions
Loans and receivables:		
Trade receivables	22	18
Other receivables	24	27
	<u>46</u>	<u>45</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

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

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

The following principles guide the Group's liquidity and funding risk management framework:

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

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

Contingency Funding Plan

A CFP is prepared for the UK Defined Liquidity Group ("DLG") which consists of the Company, and two other UK Morgan Stanley Group undertakings, being MSSL, whose institutional securities business was substantially transferred to the Group in the first quarter of 2015, and Morgan Stanley Bank International Limited. The Company is the largest component of the DLG. The 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Liquidity Stress Tests (continued)

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; and
- Maturity roll-off of outstanding letters of credit with no further issuance.

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 Liquidity Stress Tests assume that a legal entity will use its own liquidity first to fund its 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 31 December 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 Group's 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 highly liquid securities include primarily US government securities in addition to non-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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Funding Management

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

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

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

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

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

Maturity analysis

In the following maturity analysis of financial liabilities, derivative contracts and other financial liabilities held as part of the Group's trading activities are presented at fair value, consistent with how these financial liabilities are managed, and disclosed as on demand. Derivatives not held as part of the Group's trading activities and financial liabilities designated at fair value through profit or loss are disclosed according to their earliest contractual maturity; all such amounts are presented at their fair value, consistent with how these financial liabilities are managed. All other amounts represent undiscounted cash flows payable by the Group arising from its financial liabilities to earliest contractual maturities as at 31 December 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 CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity and funding risk (continued)

Maturity analysis (continued)

31 December 2014	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	15	-	-	-	-	-	15
Cash collateral on securities loaned	15,687	826	525	461	-	-	17,499
Securities sold under agreements to repurchase	21,210	10,692	4,551	6,430	3,092	-	45,975
Trade payables	83,561	-	-	-	-	-	83,561
Subordinated loans	-	-	-	145	1,088	9,785	11,018
Other payables	4,277	6	13	6,483	306	3,722	14,807
Financial liabilities classified as held for trading:							
Derivatives	231,255	-	-	-	-	-	231,255
Other	26,573	-	-	-	-	-	26,573
Financial liabilities designated at fair value through profit or loss							
	2,007	461	111	690	1,119	743	5,131
Total financial liabilities	384,585	11,985	5,200	14,209	5,605	14,250	435,834
Unrecognised financial instruments							
Contingent commitments	962	-	-	-	-	-	962
Letters of credit	-	-	-	-	-	1	1
Loan commitments	1,815	-	-	-	-	-	1,815
Underwriting commitments	-	-	290	-	-	-	290
Lease commitments	-	1	1	5	22	5	34
Unsettled securities purchased under agreements to resell ⁽¹⁾	24,333	464	-	-	-	-	24,797
Total unrecognised financial instruments	27,110	465	291	5	22	6	27,899

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 31 December 2014 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 31 December 2014, \$24,333 million settled within three business days.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

27. 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 (restated) ⁽²⁾	74,056	-	-	-	-	-	74,056
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 (restated) ⁽²⁾	27,179	-	-	-	-	-	27,179
Financial liabilities designated at fair value through profit or loss							
	9,463	45	252	335	2,714	314	13,123
Total financial liabilities	403,551	23,979	11,430	20,940	7,351	15,392	482,643
Unrecognised financial instruments							
Contingent commitments	821	-	-	-	-	-	821
Letters of credit	1	-	-	-	-	-	1
Loan commitments	1,870	-	-	-	-	-	1,870
Underwriting commitments	-	-	275	313	-	-	588
Lease commitments	-	1	2	5	21	9	38
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.

(2) Details of the restatement are provided in note 2.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. 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 implied 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 monitored. The Group also ensures transparency of material market risks, monitors compliance with established limits, and escalates risk concentrations to appropriate senior management.

To execute these responsibilities, the 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 analysis methodologies. These limits are designed to control market 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 rate and credit spread risk, 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, 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 market making activities 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 market making activities 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

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

Aggregate market risk limits have been approved for the Group. 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 Management 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. A set of internal processes and controls ensure that all trading positions booked by the Group are being included in VaR. The Group's Management VaR is the internal management VaR metric set up 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR (continued)

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

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

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

Sensitivity analysis

VaR for the year ended 31 December 2014

The table below presents the Management VaR for the Group's Trading portfolio on a year-end, annual average and annual high and low basis for the years ended 31 December 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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Sensitivity analysis (continued)

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

	95%/ one-day VaR for the year ended 31 December 2014				95%/ one-day VaR for the year ended 31 December 2013			
	Period end \$millions	Average \$millions	High \$millions	Low \$millions	Period end \$millions	Average \$millions	High \$millions	Low \$millions
<i>Market risk category:</i>								
Interest rate and credit spread	12	12	16	9	15	13	24	9
Equity price	13	12	15	10	14	14	32	11
Foreign exchange rate	4	3	6	2	5	4	8	2
Commodity price	1	1	4	-	1	1	2	1
Less diversification benefit (1)(2)	(12)	(11)	N/A	N/A	(15)	(12)	N/A	N/A
Primary Risk Categories	18	17	21	14	20	20	37	15
Credit Portfolio	6	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	21	19	24	15	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 also are taken into account within each category.

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

The Group's average Management VaR for Primary Risk Categories for 2014 was \$17 million compared with \$20 million for 2013. The decrease in average VaR for Primary Risk Categories is primarily due to reduced exposure to equity price risk.

The average Credit Portfolio VaR for 2014 was \$6 million compared with \$8 million for 2013. The decrease in the average VaR over the year was from decreased counterparty exposure during 2014.

The average total Management VaR for 2014 was \$19 million compared with \$22 million for 2013.

Non-trading risks for the year ended 31 December 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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net loss or gain of approximately \$2.7 million, compared to a net gain or loss of \$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 \$2.7 million and \$2.7 million for each 1 basis point widening in the Group's credit spread level for both 31 December 2014 and 31 December 2013.

Funding liabilities

The credit spread risk sensitivity of the Group's mark-to-market funding liabilities corresponds to an increase in value of approximately \$0.1 million and \$0.5 million for each 1 basis point widening in the Group's credit spread level for both 31 December 2014 and 31 December 2013.

Equity investments price risk

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

	31 December 2014	31 December 2013
	10% sensitivity \$millions	10% sensitivity \$millions
Available-for-sale financial assets	<u>4</u>	<u>6</u>

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

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.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

27. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk (continued)

	2014			2013		
	Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)		
	Foreign currency exposure	Percentage change applied	Other comprehensive income	Foreign currency exposure	Percentage change applied	Other comprehensive income
	\$millions	%	\$millions	\$millions	%	\$millions
Australian Dollar	(52)	14%	(7)	(40)	27%	(11)
British Pound	(29)	6%	(2)	57	11%	6
Euro	264	12%	32	479	7%	34
New Taiwan Dollar	67	8%	6	65	8%	5
New Zealand Dollar	-	7%	-	2	24%	-
Polish Zloty	3	17%	1	4	16%	1
South Korean Won	205	8%	17	203	12%	24
Swedish Krona	14	21%	3	17	9%	2
Swiss Franc	9	12%	1	11	10%	1
	<u>481</u>		<u>51</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 5 year period from 1 January 2010 to 31 December 2014 (2013: from 1 January 2009 to 31 December 2013). Thus, the percentage change applied may not be the same percentage as the actual change in the currency rate for the year.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

28. TRANSFERS OF FINANCIAL ASSETS, INCLUDING PLEDGES OF COLLATERAL

Transferred financial assets that are not derecognised in their entirety

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

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

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

These transactions are mostly conducted under standard agreements used by financial market participants and are undertaken with counterparties subject to the Group's normal credit risk control processes. The resulting credit exposures are controlled by daily monitoring and collateralisation of the positions. The carrying amount of the associated financial liabilities related to financial assets transferred that continue to be recognised is \$45,953 million.

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

	2014	2013
	\$millions	\$millions
Financial assets classified as held for trading		
Government debt securities	14,568	15,599
Corporate and other debt	5,625	5,681
Corporate equities	30,548	38,006
	<u>50,741</u>	<u>59,286</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

29. FINANCIAL ASSETS ACCEPTED AS COLLATERAL

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

The fair value of collateral accepted under these arrangements as at 31 December 2014 was \$188,375 million (2013: \$171,914 million). Of this amount \$139,243 million (2013: \$130,137 million) has been sold or repledged to third parties in connection with financing activities, or to comply with commitments under short sale transactions.

30. 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 27 for further details. Primarily in connection with securities purchased under agreements to resell and securities sold under agreements to repurchase, securities borrowed and securities loaned transactions and derivative transactions, the Group enters into master netting arrangements and collateral arrangements with its counterparties. These agreements provide the Group with the right, in the ordinary course of business and/ or in the event of a counterparty default (such as bankruptcy or a counterparty's failure to pay or perform), to net a counterparty's rights and obligations under such agreement and, in the event of counterparty default, set off collateral held by the Group against the net amount owed by the counterparty. However, in certain circumstances, the Group may not have such an agreement in place; the relevant insolvency regime (which is based on type of counterparty entity and the jurisdiction of organisation of the counterparty) may not support the enforceability of the agreement; or the Group may not have sought legal advice to support the enforceability of the agreement. In cases where the Group has not determined an agreement to be enforceable, the related amounts are not offset in the tabular disclosures. The Group's policy is generally to take possession of securities purchased under agreements to resell and securities borrowed, and to receive securities and cash posted as collateral (with rights of rehypothecation), although in certain cases the Group may agree for such collateral to be posted to a third party custodian under a tri-party arrangement that enables the Group to take control of such collateral in the event of a counterparty default. The enforceability of the master netting agreement is taken into account in the Group's risk management practices and application of counterparty credit limits. The Group also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral as provided under the applicable agreement to ensure such transactions are adequately collateralised.

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

The following tables present information about the offsetting of financial instruments and related collateral amounts. The tables do 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 27.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

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

	Gross amounts ⁽¹⁾	Amounts offset in the consolidated statement of financial position ⁽²⁾⁽³⁾	Net amounts presented in the consolidated statement of financial position	Amounts not offset in the consolidated statement of financial position ⁽⁴⁾⁽⁵⁾⁽⁶⁾		Net exposure ⁽⁷⁾
	\$millions	\$millions	\$millions	Financial instruments \$millions	Cash collateral \$millions	\$millions
31 December 2014						
Assets						
Loans and receivables:						
Cash collateral on securities borrowed	39,701	(19,010)	20,691	(19,770)	-	921
Securities purchased under agreement to resell	86,595	(27,871)	58,724	(57,640)	-	1,084
Financial assets classified as held for trading:						
Derivatives	296,542	(61,269)	235,273	(194,201)	(30,717)	10,355
TOTAL	422,838	(108,150)	314,688	(271,611)	(30,717)	12,360
Liabilities						
Financial liabilities at amortised cost:						
Cash collateral on securities loaned	36,509	(19,010)	17,499	(17,415)	-	84
Securities sold under agreement to repurchase	73,782	(27,871)	45,911	(42,344)	-	3,567
Financial liabilities classified as held for trading:						
Derivatives	284,398	(53,143)	231,255	(195,083)	(24,015)	12,157
TOTAL	394,689	(100,024)	294,665	(254,842)	(24,015)	15,808

- (1) Amounts include \$697 million of cash collateral on securities borrowed, \$1,080 million of securities purchased under agreements to resell, \$4,602 million of financial assets classified as held for trading - derivatives, \$60 million of cash collateral on securities loaned, \$3,359 million of securities sold under agreements to repurchase and \$3,920 million of financial liabilities classified as held for trading - derivatives which are either not subject to master netting agreements or collateral agreements or are subject to such agreements but the Group has not determined the agreements to be legally enforceable.
- (2) Amounts are reported on a net basis in the consolidated statements of financial position when there is a legally enforceable master netting arrangement that provides for a current right of offset and there is an intention to either settle on a net basis or to realise the asset and liability simultaneously.
- (3) Amounts include \$9,272 million and \$1,153 million of cash collateral related to financial assets classified as held for trading - derivatives recognised in amounts offset in the consolidated statement of financial positions for assets and liabilities respectively.
- (4) Amounts relate to master netting arrangements and collateral arrangements which have been determined by the Group to be legally enforceable but do not meet all criteria required for net presentation within the consolidated statement of financial position.
- (5) The cash collateral not offset is recognised in the consolidated statement of financial position within trade receivables and payables respectively.
- (6) Certain financial assets and financial liabilities designated at fair value through profit or loss have legally enforceable master netting arrangements in place; however, these are not eligible for netting within the consolidated statement of financial position. \$2 million not presented net within the consolidated statement of financial position have legally enforceable netting arrangements in place and can be offset in the ordinary course of business and/ or in the event of default.
- (7) Of the residual net exposure, intercompany cross-product legally enforceable netting arrangements are in place which would allow for an additional \$2,928 million to be offset in the ordinary course of business and / or in the event of default.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2014

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

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

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

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

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

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

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

31. 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.

2014

	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	7,350	3,492	39	10,881
Corporate and other debt	1	10,754	496	11,251
Corporate equities	37,192	682	119	37,993
Derivatives	381	230,723	4,169	235,273
Total financial assets classified as held for trading	44,924	245,651	4,823	295,398
Financial assets designated at fair value through profit or loss	-	2,044	1,316	3,360
Available-for-sale financial assets:				
Corporate equities	2	-	40	42
Total financial assets measured at fair value	44,926	247,695	6,179	298,800
Financial liabilities classified as held for trading:				
Government debt securities	7,094	1,829	-	8,923
Corporate and other debt	-	2,213	6	2,219
Corporate equities	15,351	77	3	15,431
Derivatives	252	226,000	5,003	231,255
Total financial liabilities classified as held for trading	22,697	230,119	5,012	257,828
Financial liabilities designated at fair value through profit or loss	-	5,062	69	5,131
Total financial liabilities measured at fair value	22,697	235,181	5,081	262,959

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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 (restated) ⁽¹⁾	7,170	1,762	8	8,940
Corporate and other debt (restated) ⁽¹⁾	3	11,155	714	11,872
Corporate equities (restated) ⁽¹⁾	40,223	2,578	68	42,869
Derivatives	1,256	259,656	3,881	264,793
Total financial assets classified as held for trading	48,652	275,151	4,671	328,474
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	48,654	281,226	6,327	336,207
Financial liabilities classified as held for trading:				
Government debt securities (restated) ⁽¹⁾	6,966	2,212	-	9,178
Corporate and other debt (restated) ⁽¹⁾	4	2,690	47	2,741
Corporate equities (restated) ⁽¹⁾	14,753	500	7	15,260
Derivatives	851	248,173	4,411	253,435
Total financial liabilities classified as held for trading	22,574	253,575	4,465	280,614
Financial liabilities designated at fair value through profit or loss	-	12,866	257	13,123
Total financial liabilities measured at fair value	22,574	266,441	4,722	293,737

(1) Details of the restatement are provided in note 2.

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:

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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

• *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 considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

RMBS, CMBS and other ABS are generally categorised in Level 2 of the fair value hierarchy. If external prices or 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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 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, deal structures and 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 CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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)

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 CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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 CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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)

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. 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, and commodity or equity prices. Independent, external and traded prices for the notes are considered as well. The impact of own credit spreads is also included based on observed secondary bond market spreads. Most structured notes and prepaid OTC contracts are categorised in Level 2 of the fair value hierarchy.

- *Customer Loans*

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

There were no material transfers between Level 1 and Level 2 of the fair value hierarchy during the year (2013: \$nil).

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

The following tables present the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the year ended 31 December 2014. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realised and unrealised gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realised and unrealised gains (losses) on hedging instruments that have been classified by the Group within the Level 1 and/or Level 2 categories.

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

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

	Balance at 1 January 2014 \$millions	Total gains/ (losses) recognised in consolidated income statement \$millions	Total gains/ (losses) recognised in consolidated statement of comprehensive income \$millions	Purchases \$millions	Sales \$millions	Issuances \$millions	Settlements \$millions	Net transfers in and/or (out) of Level 3 (1) \$millions	Balance at 31 December 2014 \$millions	Unrealised gains/ (losses) for Level 3 assets/ liabilities outstanding as at 31 December 2014 (2) \$millions
2014										
Financial assets classified as held for trading:										
Government debt securities	8	1	-	37	(7)	-	-	-	39	-
Corporate and other debt	714	27	-	262	(315)	-	(209)	17	496	(1)
Corporate equities	68	19	-	65	(72)	-	-	39	119	(2)
Total financial assets classified as held for trading	790	47	-	364	(394)	-	(209)	56	654	(3)
Financial assets designated at fair value through profit or loss	1,598	(12)	-	935	-	-	(1,333)	128	1,316	(11)
Available-for-sale financial assets:										
Corporate equities	58	-	(5)	-	(13)	-	-	-	40	-
Total financial assets measured at fair value	2,446	35	(5)	1,299	(407)	-	(1,542)	184	2,010	(14)
Financial liabilities classified as held for trading:										
Corporate and other debt	47	(11)	-	(23)	11	-	-	(40)	6	(2)
Corporate equities	7	2	-	(55)	51	-	-	2	3	2
Net derivative contracts ⁽³⁾⁽⁴⁾	530	(22)	-	(1,029)	-	946	395	(30)	834	(4)
Total financial liabilities classified as held for trading	584	(31)	-	(1,107)	62	946	395	(68)	843	(4)
Financial liabilities designated at fair value through profit or loss	257	-	-	-	-	70	(247)	(11)	69	1
Total financial liabilities measured at fair value	841	(31)	-	(1,107)	62	1,016	148	(79)	912	(3)

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

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2014 related to assets and liabilities still outstanding at 31 December 2014. The unrealised gains or (losses) are recognised in the consolidated income statement or consolidated statement of comprehensive income as detailed in the financial instruments accounting policy (note 3c).

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

(4) During the year, the Group incurred a charge of approximately \$273 million related to the implementation of FVA, which was recognised within 'net gains on financial instruments classified as held for trading' the consolidated income statement as detailed in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

2013	Balance at 1 January 2013 \$millions	Total gains/(losses) recognised in consolidated income statement \$millions	Total gains/(losses) recognised in consolidated statement of comprehensive income \$millions	Purchases \$millions	Sales \$millions	Issuances \$millions	Settlements \$millions	Net transfers in and/or (out) of Level 3 (1) \$millions	Balance at 31 December 2013 \$millions	Unrealised gains/(losses) for Level 3 assets/liabilities outstanding as at 31 December 2013 (2) \$millions
Financial assets classified as held for trading:										
Government debt securities (restated) ⁽⁴⁾	2	(4)	-	13	(5)	-	-	2	8	(4)
Corporate and other debt	965	126	-	269	(363)	-	(254)	(29)	714	38
Corporate equities (restated) ⁽⁴⁾	121	(20)	-	7	(59)	-	-	19	68	(23)
Total financial assets classified as held for trading	1,088	102	-	289	(427)	-	(254)	(8)	790	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	1,703	169	-	1,665	(439)	-	(644)	(8)	2,446	11
Financial liabilities classified as held for trading:										
Corporate and other Debt (restated) ⁽⁴⁾	50	1	-	(19)	48	-	-	(31)	47	2
Corporate equities (restated) ⁽⁴⁾	5	2	-	(4)	6	-	-	2	7	1
Net derivative contracts ⁽⁵⁾	1,232	291	-	(1,302)	-	1,624	(681)	(52)	530	103
Total financial liabilities classified as held for trading	1,287	294	-	(1,325)	54	1,624	(681)	(81)	584	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	1,595	290	-	(1,395)	66	1,693	(747)	(81)	841	102

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

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

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

(4) Details of the restatement are provided in note 2.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

There were no material transfers from Level 2 to Level 3 or from Level 3 to Level 2 of the fair value hierarchy during the year (2013: \$nil).

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

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

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

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

31. 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 2014

ASSETS	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 assets classified as held for trading:					
- Corporate equities	119	Comparable pricing	Comparable equity price / (A)	100%	100%
		Market Approach	EBITDA Multiple / (A)	7 to 9 times	8 times
- Government debt securities	39	Comparable pricing	Comparable bond price / (A)	119% to 122%	120%, 121%
- Corporate and other debt:					
- Residential mortgage backed securities	100	Comparable pricing	Comparable bond price / (A)	3 to 96 points	22 points
- Commercial mortgage backed securities	44	Comparable pricing	Comparable bond price / (A)	3 to 5 points	4 points
- Asset backed securities	78	Comparable pricing	Comparable bond price / (A)	0 to 100 points	100 points
- Corporate bonds	140	Comparable pricing	Comparable bond price / (A)	1 to 117 points	64 points
		Option Model	At the money volatility / (A)	15% to 54%	26%
		Option Model	Volatility skew / (A)	-3% to 0%	-1%
- Collateralised debt obligations	109	Comparable pricing	Comparable loan price / (A)	71 to 100 points	91 points
Financial assets designated at fair value through profit or loss:					
- Customer loans	1,296	Margin Loan Model	Credit spread / (C)(D)	353 to 451 bps	402bps
		Margin Loan Model	Volatility skew / (C)(D)	3% to 37%	25%
		Margin Loan Model	Comparable price / (A)(D)	80% to 120%	100%
		Option Model	Volatility skew / (C)	-1%	-1%
Available-for-sale financial assets:					
- Corporate equities	40	Comparable pricing	Comparable equity price / (A)	100%	100%

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

LIABILITIES

Financial liabilities classified as held for trading:

- Net derivatives contracts:(1) (4)

- Credit	(6)	Correlation Model	Credit correlation / (B)	46% to 88%	61%
			Comparable pricing	Comparable bond price / (C)(D)	2 to 99 points
- Equity	(1,033)	Option Model	At the money volatility / (C)(D)	15% to 50%	29%
			Volatility skew / (C)(D)	-4% to 1%	-1%
			Equity correlation / (C)(D)	30% to 99%	70%
			Equity Foreign exchange correlation / (C)(D)	-40% to 10%	-16%
- Interest rate	25	Option Model	Inflation volatility / (A)(D)	69% to 71%	70%, 71%
			Interest rate curve / (A)(D)	0% to 2%	1%, 1%
			Interest rate - foreign exchange correlation / (C)(D)	28% to 62%	44%, 42%
			Interest rate - inflation correlation / (A)(D)	-44% to -40%	-42%, -43%
			Interest rate curve correlation / (C)(D)	44% to 87%	73%, 80%
			Interest rate quanto correlation / (C)(D)	-9% to 35%	6%, -6%
			Interest rate volatility skew / (A)(D)	38% to 104%	86%, 60%
- Foreign exchange	228	Option Model	Interest rate curve/ (A)(D)	0% to 2%	1%, 1%
			Interest rate - foreign exchange correlation / (C)(D)	28% to 62%	44%, 42%
			Interest rate curve correlation / (C)(D)	44% to 87%	73%, 80%
			Interest rate quanto correlation / (C)(D)	-9% to 35%	6%, -6%
			Interest rate volatility skew / (A)(D)	38% to 104%	86%, 60%
- Commodity	(48)	Option Model	Cross commodity correlation/ (C)	33% to 100%	93%
Financial liabilities designated at fair value through profit or loss					
- Prepaid OTC contracts	(52)	Option Model	At the money volatility / (C)(D)	6% to 33%	19%
			Cash synthetic basis / (C)(D)	15 points	15 points

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

(2) The ranges of significant unobservable inputs are represented in points, percentages or basis points. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point (bps) equals 1/100th of 1%; for example, 353 basis points would equal 3.53%.

(3) Amounts represent weighted averages except where simple averages and the median of the inputs are provided (see footnote 5 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) CVA and FVA are included in the fair value, but excluded from the valuation techniques and significant unobservable inputs in the table above. CVA is deemed to be a Level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

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

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

31. 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

ASSETS	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 assets classified as held for trading:					
- Corporate equities (restated) ⁽⁶⁾	68	Net Asset Value	Discount to net asset value / (C)	0% to 34%	0%
		Net Asset Value	Discount to net asset value / (C)	40% to 50%	50%
		Comparable pricing	Comparable equity price / (C)	0% to 100%	50%
		Market Approach	EBITDA Multiple / (C)	5 times to 9.3 times	7.7 times
- Corporate and other debt:					
- Commercial mortgage backed securities	28	Comparable pricing	Comparable bond price / (A)	1 to 20 points	10 points
- Asset backed securities	39	Correlation model	Credit Correlation / (B)	29% to 55%	47%
		Comparable pricing	Comparable bond price / (A)	56 points	56 points
- Corporate bonds	201	Comparable pricing	Comparable bond price / (A)	5 to 133 points	106 points
		Option Model	At the money volatility / (A)	11% to 56%	25%
		Option Model	Volatility skew / (A)	-3% to 0%	-1%
		Comparable pricing	Comparable bond price / (A)	55 to 56 points	56 points
- Collateralised debt obligations	119	Comparable pricing	Comparable loan price / (A)	76 to 95 points	89 points
		Correlation Model	Credit Correlation / (B)	39% to 45%	40%
- Loans and lending commitments	110	Comparable pricing	Comparable loan price / (A)	0 to 100 points	95 points
- Other debt	193	Comparable pricing	Comparable bond price / (A)	99 to 101 points	101 points
Financial assets designated at fair value through profit or loss:					
- Customer loans	1,596	Margin Loan Model	Credit spread / (C)(D)	10 to 265 bps	170bps
		Margin Loan Model	Volatility skew / (C)(D)	3% to 4%	4%
		Margin Loan Model	Comparable price / (A)(D)	80% to 120%	100%
		Option Model	Volatility skew / (C)	0%	0%

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

LIABILITIES

Financial liabilities classified as held for trading:

- Corporate and other debt:

- Other debt	(39) Option Model	At the money volatility / (A)	31%	31%
<hr/>				
- Net derivatives contracts: ⁽¹⁾⁽⁵⁾				
- 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	Credit Spread / (C)(D)	2 to 5 points	4 points
<hr/>				
- Equity	(754) Option Model	At the money volatility / (C)(D)	16% to 57%	29%
		Volatility skew / (C)(D)	-3% to 0%	-1%
		Equity correlation / (C)(D)	40% to 99%	67%
		Equity Foreign exchange correlation / (C)(D)	-30% to 9%	-20%
<hr/>				
- Interest rate	74 Option Model	Comparable bond price / (A)(D)	5 to 100 points	58, 65 points
		Inflation volatility / (A)(D)	77% to 86%	81%, 80%
		Interest rate / (A)(D)	0% to 1%	1%, 0%
		NAV / (A)(D)	\$0 to \$121	\$63
		Interest rate - foreign exchange correlation / (A)(D)	3% to 63%	43%, 48%
		Interest rate curve correlation / (A)(D)	46% to 92%	74%, 80%
		Interest rate quanto correlation / (A)(D)	-11% to 34%	8%, 5%
		Interest rate volatility skew / (A)(D)	24% to 50%	33%, 28%
<hr/>				
- Foreign exchange	151 Option Model	Interest rate / (A)(D)	0% to 1%	1%, 0%
		Interest rate - foreign exchange correlation / (A)(D)	3% to 63%	43%, 48%
		Interest rate curve correlation / (A)(D)	46% to 92%	74%, 80%
		Interest rate quanto correlation / (A)(D)	-11% to 34%	8%, 5%
		Interest rate volatility skew / (A)(D)	24% to 50%	33%, 28%
<hr/>				
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 bps to 147 bps	129 bps
<hr/>				
- Other	(188) Comparable pricing	Comparable bond price / (A)	99 to 101 points	101 points

- (1) Net derivative contracts represent financial assets classified as held for trading – derivative contracts net of financial liabilities classified as held for trading – derivative contracts. In addition, there are other derivative contracts with a fair value of \$7 million not included within one of the major derivative categories.
- (2) The ranges of significant unobservable inputs are represented in points, percentages or basis points. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point (bps) equals 1/100th of 1%; for example, 265 basis points would equal 2.65%.
- (3) Amounts represent weighted averages except where simple averages and the median of the inputs are provided (see footnote 4 below). Weighted averages are calculated by weighting each input by the fair value of the respective financial instruments except for derivative instruments where inputs are weighted by risk.
- (4) The data structure of the significant unobservable inputs used in valuing Interest rate contracts and certain Equity contracts may be in a multi-dimensional form, such as a curve or surface, with risk distributed across the structure. Therefore, a simple average and median, together with the range of data inputs, may be more appropriate measurements than a single point weighted average.
- (5) Includes derivative contracts with multiple risks (i.e. hybrid products)
- (6) Details of the restatement are provided in note 2.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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:

- *Cash synthetic basis*—the measure of the price differential between cash financial instruments (“cash instruments”) and their synthetic derivative-based equivalents (“synthetic instruments”). The range disclosed in the table above signifies the number of points by which the synthetic bond equivalent price is higher than the quoted price of the underlying cash bonds.
- *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.
- *Comparable equity price* – a price derived from equity raises, share buybacks and external bid levels, etc. A discount or premium may be included in the fair value estimate.
- *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* – the ratio of the Enterprise Value to EBITDA, 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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)

- *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 and certain other secured financings are discounted based on collateral curves. The curves are constructed as spreads over the corresponding overnight indexed swap (“OIS”) or LIBOR curves, with the short end of the curve representing spreads over the corresponding OIS curves and the long end of the curve representing spreads over LIBOR.
- *Interest rate curve* – the term structure of interest rates (relationship between interest rates and the time to maturity) and a market’s measure of future interest rates at the time of observation. An interest rate curve is used to set interest rate and foreign exchange derivative cash flows and is a pricing input used in the discounting of any OTC derivative cash flow.
- *Internal rate of return* – the discount factor required for the net present value of future cash flows to equal zero. The internal rate of return represents the minimum average annual return required for an investment.
- *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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. 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

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.

MORGAN STANLEY & CO. INTERNATIONAL plc

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Year ended 31 December 2014

31. 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)

2014	Fair value \$millions	Effect of reasonably possible alternative assumptions	
		Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
Government debt securities	39	-	-
Corporate and other debt	496	19	(16)
Corporate equities	119	2	(9)
Financial assets designated at fair value through profit or loss:			
Prepaid OTC contracts	20	-	-
Customer loans	1,296	2	(3)
Available-for-sale financial assets:			
Corporate equities	40	9	(2)
Financial liabilities classified as held for trading:			
Corporate and other debt	6	-	-
Corporate equities	3	-	-
Net derivatives contracts ⁽¹⁾⁽²⁾	834	152	(163)
Financial liabilities designated at fair value through profit or loss:			
Prepaid OTC contracts	52	2	(1)
Other	17	-	-

(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) CVA and FVA are included in the fair value, but excluded from the effect of reasonably possible alternative assumptions in the table above. CVA is deemed to be a level 3 input when the underlying counterparty credit curve is unobservable. FVA is deemed to be a Level 3 input in its entirety given the lack of observability of funding spreads in the principal market.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

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

2013	Fair value \$millions	Effect of reasonably possible alternative assumptions	
		Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
Government debt securities (restated) ⁽²⁾	8	-	-
Corporate and other debt	714	21	(18)
Corporate equities (restated) ⁽²⁾	68	2	(4)
Financial assets designated at fair value through profit or loss:			
Prepaid OTC contracts	2	-	-
Customer loans	1,596	1	(2)
Available-for-sale financial assets:			
Corporate equities	58	-	-
Financial liabilities classified as held for trading:			
Corporate and other debt	47	-	-
Corporate equities (restated) ⁽²⁾	7	-	-
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) Details of the restatement are provided in note 2.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

31. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

e. Financial instruments valued using unobservable market data

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

	2014	2013
	\$millions	\$millions
At 1 January	351	559
New transactions	26	60
Amounts recognised in the consolidated income statement during the year	(143)	(268)
At 31 December	<u>234</u>	<u>351</u>

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

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

32. FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE

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

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

31 December 2014

	Carrying value	Fair value	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)
	\$millions	\$millions	\$millions	\$millions	\$millions
Financial liabilities					
Subordinated loans	7,906	8,064	-	8,064	-
Other payables	3,166	2,845	-	2,845	-

31 December 2013

	Carrying value	Fair value	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)
	\$millions	\$millions	\$millions	\$millions	\$millions
Financial liabilities					
Subordinated loans	7,906	8,117	-	8,117	-
Other payables	3,198	2,325	-	2,325	-

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

The fair value of other payables is determined based on current interest rates and credit spreads for debt instruments with similar terms and maturity. Also included in the consolidated statement of financial position is \$10,968 million (2013: \$14,981 million) of other payables where the carrying value is a reasonable approximation of fair value.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

33. CAPITAL MANAGEMENT

The Group views capital as an important source of financial strength. The Morgan Stanley Group manages its capital position based upon, among other things, business opportunities, risks, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and, therefore, in the future may expand or contract its capital base to address the changing needs of its businesses. The appropriate level of capital is determined at a legal entity level to safeguard that entity's ability to continue as a going concern and ensure that it meets all regulatory capital requirements. The key components of the capital management framework used by the Company are set out in the Capital Management Policy and include a point in time capital assessment, forward looking capital projections and stress testing.

On 1 January 2014, the EC implemented the Capital Requirements Directive and Capital Requirements Regulation (together, "CRD IV"). The Company was compliant with the new rules from that date.

MSI and all of its subsidiary undertakings (together "the MSI Group") prepare an Internal Capital Adequacy Assessment Process ("ICAAP") document in order to meet its obligations under the Capital Requirements Directive and the requirements of the PRA.

The ICAAP is one of the key tools used to inform the MSI Group's capital adequacy assessment, planning and management. The MSI Group ICAAP:

- Ensures the risks the MSI Group is exposed to are appropriately capitalised and risk managed, including those risks that are either not captured, or not fully captured under Pillar 1;
- Uses stress testing to size a capital buffer aimed at ensuring the MSI Group will continue to operate above regulatory requirements under a range of severe but plausible stress scenarios; and
- Assesses capital adequacy under normal and stressed operating environments over the 3 year capital planning horizon to ensure the MSI Group maintains a capital position in line with internal operating targets and above post stress minimums

The key elements of the ICAAP are embedded in the MSI Group's day-to-day management processes and decision making culture

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

The capital managed by the Group broadly includes share capital, Additional Tier 1 capital instruments, subordinated debt and reserves. In order to maintain or adjust its capital structure, the Group may adjust the amount of dividends paid, return capital to its shareholder, issue new shares, issue or repay subordinated debt or sell assets to reduce debt. During the year the Group issued Additional Tier 1 capital to further improve its capital. Details of its managed capital are set out in the table below.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

33. CAPITAL MANAGEMENT (CONTINUED)

The Group manages the following items as capital:

	2014 \$millions	2013 \$millions
Ordinary share capital	11,464	11,464
Additional Tier 1 capital	1,300	-
Subordinated debt	7,906	7,906
Reserves	3,353	4,116
	<u>24,023</u>	<u>23,486</u>

Pillar 3 disclosures

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

Country-by-Country Reporting

The Company is included in the MSI consolidated disclosure in order to comply with the provisions of Statutory Instrument 2013 No.3118 Capital Requirements (Country-by-Country Reporting) Regulations 2013, which implements in the UK the requirements set out in Article 89 of the Capital Requirements Directive (Directive 2013/36/EU). The MSI Group disclosure for the year ended 31 December 2014 will be made available by 31 December 2015 on the Morgan Stanley website at www.morganstanley.com/investorrelations, where the 2013 disclosure for the MSI Group can also be found.

34. EMPLOYEE COMPENSATION PLANS

Morgan Stanley maintains various deferred compensation plans for the benefit of its employees. The two principal forms of deferred compensation are granted under stock based compensation and deferred cash based compensation plans.

Equity-settled share-based compensation plans

- **Restricted stock units**

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

During the year, Morgan Stanley granted 524,558 (2013: 795,890) of restricted stock units to employees of the Group with a weighted average fair value per unit of \$32.58 (2013: \$22.52), based on the market value of Morgan Stanley shares at grant date.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

34. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Equity-settled share-based compensation plans (continued)

- **Stock options**

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

There were no options granted during the year (2013: none).

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

	2014		2013	
	Number of options '000s	Weighted average exercise price \$	Number of options '000s	Weighted average exercise price \$
Options outstanding at 1 January	118	56.81	174	50.94
Expired during the year	(57)	47.19	(56)	38.64
Options outstanding and exercisable at 31 December	<u>61</u>	<u>65.73</u>	<u>118</u>	<u>56.81</u>

There were no options exercised during the year (2013: none).

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

Range of exercise prices	Number of options '000s	2014		Number of options '000s	2013	
		Weighted average exercise price \$	Weighted average remaining life in years		Weighted average exercise price \$	Weighted average remaining life in years
\$40.00 - \$49.99	3	43.15	-	59	47.01	-
\$60.00 - \$69.99	58	66.73	2.0	59	66.73	3.0
Total	<u>61</u>	<u>65.73</u>	<u>1.9</u>	<u>118</u>	<u>56.81</u>	<u>1.5</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

34. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Deferred cash-based compensation plans

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

Awards with a value of \$17 million (2013: \$18 million) have been granted to employees during the year and an expense of \$25 million (2013: \$23 million) has been recognised within 'Direct staff costs' in 'Other expense' in the consolidated income statement in relation to current and previous years' awards. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the consolidated statement of financial position, is \$26 million (2013: \$18 million).

The Group economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation schemes is \$nil (2013: \$1 million), and recognised within 'Financial liabilities classified as held for trading' is \$3 million (2013: \$3 million). The related loss recorded within 'Net gains on financial instruments classified as held for trading' for the year is \$nil (2013: \$1 million profit).

Plans operated by fellow Morgan Stanley undertakings

As described in note 7, the Group utilises staff employed by other Morgan Stanley Group undertakings and incurs management charges in respect of these employee services. The management charge includes both the cost of equity based and cash based deferred compensation provided to these employees.

35. POST EMPLOYMENT BENEFITS

Defined contribution plans

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

The defined contribution plans are as follows:

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

The defined contribution pension charge in relation to the above schemes recognised within 'Staff costs' in 'Other expense' in the consolidated income statement was \$3 million for the year (2013: \$3 million) of which \$nil was accrued at 31 December 2014 (2013: \$nil).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

35. POST EMPLOYMENT BENEFITS (CONTINUED)

Defined benefit plans

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

The defined benefits plans are as follows:

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

The defined benefit pension charge in relation to the above plans recognised in 'Staff costs' in 'Other expense' in the consolidated income statement was \$2 million for the year (2013: \$2 million). The cumulative amount of actuarial gains and losses recognised in other comprehensive income is a \$3 million gain for the year (2013: \$4 million gain). A net liability of \$5 million (2013: \$4 million) is recognised in the Group's consolidated statement of financial position in respect of these plans.

Plans operated by fellow Morgan Stanley undertakings

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

Defined contribution scheme

The management recharge for the year in respect of the defined contribution scheme recognised within 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' in 'Other expense' was \$58 million (2013: \$52 million).

Defined benefit section

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

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

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

The full actuarial valuation provides a funding basis for the Plan. The funding basis varies from the IAS 19 valuation as it is determined using assumptions reflective of the cost of securing the benefits built up in the Plan with an insurance company. The position is reviewed each year as part of the annual funding update.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

35. POST EMPLOYMENT BENEFITS (CONTINUED)

Defined benefit section (continued)

There is no contractual arrangement for recharging the net defined benefit cost of the Plan as a whole measured in accordance with IAS 19. Accordingly, in line with IAS 19, the Group recognises its contribution payable for the period as an expense. On this basis, the management recharge for the year in respect of the defined benefit plan recognised within 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' in 'Other expense' was \$11 million (2013: \$11 million).

The full actuarial valuation at 31 December 2012 indicated a deficit on a funding basis of \$22 million. A schedule of contributions was agreed by the Trustees and MSUK on 31 October 2013 on the basis of the funding deficit which, based upon the assumptions used is expected to eliminate the shortfall by 31 January 2015. MSUK expects to contribute \$1 million (2013: \$11 million) in the next financial year based upon the schedule of contributions agreed.

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

On an IAS 19 basis, the Plan has a surplus of scheme assets over liabilities. The full actuarial valuation as at 31 December 2012, adjusted as appropriate for the requirements of IAS 19, was updated by a qualified actuary at 31 December 2014 to allow for changes in market conditions and actuarial assumptions. The liabilities of the Plan are measured by discounting the best estimate of future cash flows to be paid out by the Plan using the projected unit method. Under this method, each participant's benefits under the Plan are attributed to years of service, taking into consideration the Plan's benefit allocation formula. For the defined benefit section of the Plan, accrual of future benefits ceased in 1996 and no further benefit has been attributed to service during subsequent reporting periods. The accumulated benefit obligation is therefore an actuarial measure of the present value of benefits for service already rendered and includes no assumption for future salary increases. An assumption for revaluation in deferment is built into the valuation of the scheme. This revaluation preserves the benefits accrued and prevents the benefit diminishing over time through the effects of inflation.

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

	2014	2013
	\$millions	\$millions
Present value of the funded defined benefit obligation	(264)	(198)
Fair value of plan assets	343	257
Surplus of the funded defined benefit plan	79	59
Impact of asset ceiling	(79)	(59)
Net asset	-	-

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

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014**

35. POST EMPLOYMENT BENEFITS (CONTINUED)

Actuarial assumptions

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

	2014	2013
	%	%
Pre retirement discount rate	3.3	4.5
Post retirement discount rate	2.9	3.9
Inflation	3.1	3.6
Revaluation in deferment	2.1	2.6

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

	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
	Aged 65	Aged 45	Aged 65	Aged 45
31 December 2014				
UK	90.0	92.1	92.1	94.5
31 December 2013				
UK	89.9	92.0	92.0	94.4

Plan assets

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

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

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

35. POST EMPLOYMENT BENEFITS (CONTINUED)

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

	2014	2013
	\$millions	\$millions
Cash funds	53	56
Corporate bond index funds	56	42
Government bond index funds:		
UK Gilt index funds	135	81
GBP fixed liability matching funds	87	78
Fixed Gilts	12	-
	<hr/> 343	<hr/> 257
	<hr/> <hr/>	<hr/> <hr/>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

36. RELATED PARTY DISCLOSURES

Parent and subsidiary relationships

Parent and ultimate controlling entity

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

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

Key management compensation

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

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

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

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

	2014	2013
	\$millions	\$millions
Short-term employee benefits	50	29
Post-employment benefits	1	1
Share-based payments	31	40
Other long-term employee benefits	30	36
Termination benefits	-	3
	<u>112</u>	<u>109</u>

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

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

36. RELATED PARTY DISCLOSURES (CONTINUED)

Directors' remuneration

	2014 \$millions	2013 \$millions
Total remuneration of all Directors:		
Aggregate remuneration	16	5
Long term incentive schemes	6	10
	22	15
Disclosures in respect of the highest paid Director:		
Aggregate remuneration	4	1
Long term incentive schemes	2	3
	6	4

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

Directors who are employees of the Morgan Stanley Group are eligible for shares and share options of the parent company, Morgan Stanley, awarded under the Morgan Stanley Group's equity-based long-term incentive schemes. In accordance with Schedule 5 paragraph 1(3)(a) of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the above disclosures include neither the value of shares awarded, nor the gains made on exercise of share options. During the year under these incentive schemes, no Directors exercised share options (2013: none) and seven Directors received deferred stock unit awards in respect of qualifying services, including the highest paid Director (2013: six).

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

There are six Directors to whom retirement benefits are accruing under a money purchase scheme (2013: five). In addition, three Directors have benefits accruing under a Morgan Stanley non-UK defined benefits scheme (2013: three).

Transactions with related parties

The Morgan Stanley Group conducts business for clients globally through a combination of both functional and legal entity organisational structures. Accordingly, the Group is closely integrated with the operations of the Morgan Stanley Group and enters into transactions with other Morgan Stanley Group undertakings on an arm's length basis for the purposes of utilising financing, trading and risk management, and infrastructure services. The nature of these relationships along with information about the transactions and outstanding balances is given below. The Group has not recognised any expense and has made no provision for impairment relating to the amount of outstanding balances from related parties (2013: \$nil).

Cash

The Group places cash with other Morgan Stanley Group undertakings. All such transactions are entered into on an arm's length basis.

	2014		2013	
	Interest \$millions	Balance \$millions	Interest \$millions	Balance \$millions
Amounts due from other Morgan Stanley Group undertakings	-	19	1	104
	-	19	1	104
	-	19	1	104

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS Year ended 31 December 2014

36. RELATED PARTY DISCLOSURES (CONTINUED)

Funding

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

- *General funding*

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

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

	2014		2013	
	Interest \$millions	Balance \$millions	Interest \$millions	Balance \$millions
Amounts due from the Group's direct and indirect parent undertakings	4	548	39	495
Amounts due from other Morgan Stanley Group undertakings	81	2,154	95	1,836
	<u>85</u>	<u>2,702</u>	<u>134</u>	<u>2,331</u>
Amounts due to the Group's direct and indirect parent undertakings	167	5,968	171	5,198
Amounts due to other Morgan Stanley Group undertakings	389	7,902	336	10,609
	<u>556</u>	<u>13,870</u>	<u>507</u>	<u>15,807</u>

- *Subordinated loans*

The Group received a subordinated loan from another Morgan Stanley Group undertaking. Details of the terms of the loan, including the contractual maturity and the interest rate are shown in note 17. The interest rate is established by the Morgan Stanley Group Treasury function based on available market information at the time the loan is provided or subsequently amended.

Trading and risk management

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

Details of the outstanding balances included in cash collateral on securities borrowed/ loaned and securities purchased/ sold under agreements to resell/ repurchase in the consolidated statement of financial position on such transactions and the related interest income or expense recognised in the consolidated income statement during the year are shown in the table below:

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

36. RELATED PARTY DISCLOSURES (CONTINUED)

Trading and risk management (continued)

	2014		2013	
	Interest \$millions	Balance \$millions	Interest \$millions	Balance \$millions
Amounts due from the Group's direct and indirect parent undertakings	1	-	-	-
Amounts due from other Morgan Stanley Group undertakings	(77)	36,082	267	44,214
	<u>(76)</u>	<u>36,082</u>	<u>267</u>	<u>44,214</u>
Amounts due to the Group's direct and indirect parent undertakings	16	8,930	13	4,685
Amounts due to other Morgan Stanley Group undertakings	68	20,406	489	18,460
	<u>84</u>	<u>29,336</u>	<u>502</u>	<u>23,145</u>

The Group enters into purchases and sales of securities and derivative transactions with other Morgan Stanley Group undertakings to facilitate the provision of financial services to clients on a global basis and to manage the market risks associated with such business. The Group also enters into derivative transactions with other Morgan Stanley Group undertakings to manage the market risks associated with certain of its compensation plans. All such transactions are entered into on an arm's length basis. The total amounts receivable and payable from such transactions are included within trade receivables and trade payables in the consolidated statement of financial position and the fair value of such derivatives contracts outstanding included in financial assets/ liabilities classified as held for trading in the consolidated statement of financial position at the year end were as follows:

	Restated ⁽¹⁾	
	2014 \$millions	2013 \$millions
Amounts due from the Group's direct and indirect parent undertakings on securities and derivative transactions	4,918	1,447
Amounts due from other Morgan Stanley Group undertakings on securities and derivative transactions	63,757	99,442
	<u>68,675</u>	<u>100,889</u>
Amounts due to the Group's direct and indirect parent undertakings on securities and derivative transactions	4,269	472
Amounts due to other Morgan Stanley Group undertakings on securities and derivative transactions	58,805	94,252
	<u>63,074</u>	<u>94,724</u>

(1) Details of the restatement are provided in note 2.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Year ended 31 December 2014

36. RELATED PARTY DISCLOSURES (CONTINUED)

Trading and risk management (continued)

The Group has received collateral of \$1,978 million (2013: \$7,622 million) from other Morgan Stanley Group undertakings and has pledged collateral of \$21,272 million (2013: \$13,217 million) to other Morgan Stanley Group undertakings to mitigate credit risk on exposures arising under derivatives contracts between the Group and other Morgan Stanley Group undertakings.

In addition, the management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. For the year ended 31 December 2014, a net loss of \$1,134 million (2013: net loss of \$589 million) was transferred to other Morgan Stanley Group undertakings relating to such revenue transfer pricing policies and recognised in the consolidated income statement.

For certain business strategies transacted by the Group, where that business strategy has incurred a loss on another Morgan Stanley Group entity, policies are in place such that losses are only transferred to the Group to the extent that the losses are offset by profits arising on the same business strategy after the loss was incurred. During 2014 this has resulted in losses being incurred on other Morgan Stanley Group entities that would otherwise be transferred to the Group and may reduce future profits of the Group.

For policies for certain business strategies transacted by other Morgan Stanley Group undertakings, where that business strategy has booked positions on the Group, any losses on these positions are netted across all business strategies on each loss bearing entity and are only transferred to the relevant Morgan Stanley Group undertakings to the extent that the losses are offset by profits arising from the same population of business strategies within the other Morgan Stanley Group undertakings. In the current period this has resulted in losses being incurred by the Group that would otherwise have been transferred to other Morgan Stanley Group undertakings.

Infrastructure services

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

	2014		2013	
	Staff costs	Other	Staff costs	Other
	\$millions	services	\$millions	services
		\$millions		\$millions
Amounts recharged from the Group's direct and indirect parent undertakings	94	303	92	201
Amounts recharged from other Morgan Stanley Group undertakings	2,100	367	1,769	128
	<u>2,194</u>	<u>670</u>	<u>1,861</u>	<u>329</u>

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 December 2014

36. RELATED PARTY DISCLOSURES (CONTINUED)

Taxation

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

Other related party transactions

The Group has received a guarantee from Morgan Stanley Group (Europe), to guarantee the obligations under derivative contracts of certain fellow Morgan Stanley Group undertakings to the Company. As at 31 December 2014, no call had been made by the Group under these arrangements.

MORGAN STANLEY & CO. INTERNATIONAL plc*Registered number: 2068222***COMPANY BALANCE SHEET****As at 31 December 2014**

	Note	2014 \$millions	Restated 2013 \$millions
FIXED ASSETS			
Tangible assets	3	2	4
Investments:			
- Available-for-sale financial assets	4	38	56
- Subsidiary undertakings	4	85	87
		<u>125</u>	<u>147</u>
CURRENT ASSETS			
Financial assets classified as held for trading (of which \$43,572 million (2013: \$45,178 million) were pledged to various parties)	5	297,284	331,746
Financial assets designated at fair value through profit or loss	6	3,360	7,673
Loans and receivables:			
- Debtors	7	137,537	146,800
- Cash at bank	8	11,401	11,969
Other assets	9	443	501
		<u>450,025</u>	<u>498,689</u>
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR			
Financial liabilities classified as held for trading	5	256,646	279,444
Financial liabilities designated at fair value through profit and loss	6	3,269	9,918
Financial liabilities at amortised cost	11	157,853	176,098
Other creditors	12	218	354
		<u>417,986</u>	<u>465,814</u>
NET CURRENT ASSETS		<u>32,039</u>	<u>32,875</u>
TOTAL ASSETS LESS CURRENT LIABILITIES		<u>32,164</u>	<u>33,022</u>
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Financial liabilities designated at fair value through profit and loss	6	1,862	3,028
Financial liabilities at amortised cost	11	14,139	14,486
Other creditors	12	1	-
PROVISIONS FOR LIABILITIES	13	43	29
NET ASSETS EXCLUDING PENSION LIABILITIES		<u>16,119</u>	<u>15,479</u>
Pension liability		<u>2</u>	<u>2</u>
NET ASSETS INCLUDING PENSION LIABILITY		<u>16,117</u>	<u>15,477</u>
CAPITAL AND RESERVES			
Called up share capital and other equity instruments	14	12,764	11,464
Share premium account	15	513	513
Currency translation reserve	15	(88)	(44)
Available-for-sale reserve	15	6	5
Capital contribution reserve	15	3	3
Capital redemption reserve	15	1,400	1,400
Pension reserve	15	1	-
Profit and loss account	15	1,518	2,136
SHAREHOLDERS' FUNDS		<u>16,117</u>	<u>15,477</u>

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

These financial statements were approved by the Board and authorised for issue on 22 April 2015.

Signed on behalf of the Board

C Castello
Director

The notes on pages 126 to 153 form an integral part of the financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

1. ACCOUNTING POLICIES

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

a) Basis of preparation

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

The annual consolidated financial statements of the Group (being the Company and all of its subsidiary undertakings) presents disclosures that comply with Financial Reporting Standard ("FRS") 29 *Financial instruments: Disclosures* ("FRS 29"). Accordingly, the Company is exempt from the disclosure requirements of FRS 29.

b) Restatement of comparative amounts

In 2014 the Group changed its accounting policy for regular-way sales and purchases of held for trading non-derivative financial instruments from trade date to settlement date accounting. The Group believes that recognising and derecognising held for trading non-derivative financial instruments on settlement date results in a more relevant and reliable presentation of its financial position. Aligning recognition of all non-derivative financial instruments to a settlement date basis, more appropriately reflects the risks of these unsettled positions within the consolidated statement of financial position and results in greater comparability to the financial position of other peer organisations in the UK and the Morgan Stanley Group.

Previously, regular-way purchases and sales of held for trading non-derivative financial instruments were recorded on a trade date basis. As at 31 December 2014, the Group recognised such transactions on a settlement date. This resulted in a change to the timing of recognition and derecognition of certain non-derivative financial instruments, as well as significantly reducing the resulting trade receivables and trade payables on the consolidated statement of financial position. This accounting policy change did not have an impact on the profit or loss recorded on those instruments. A fuller description of how these financial instruments are accounted for under settlement date accounting is presented in accounting policy note 1(h) i) 'Financial instruments classified as held for trading'.

Pursuant to the requirements of IAS 8, *'Accounting Policies, Changes in Accounting Estimates and Errors'*, the Group has adjusted comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied and a third consolidated statement of financial position, as at 1 January 2013, has been presented.

This change in accounting policy had the following impact:

As at:	31 December 2014	31 December 2013
	\$millions	\$millions
Decrease in trade debtors	16,737	23,537
Decrease in financial assets classified as held for trading	914	857
Decrease in total assets	<u>17,651</u>	<u>24,394</u>
Decrease in trade creditors	18,109	23,891
(Increase)/ decrease in financial liabilities classified as held for trading	<u>(458)</u>	<u>503</u>
Decrease in total liabilities	<u>17,651</u>	<u>24,394</u>

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

c) Change in accounting framework

The Company meets the definition of a qualifying entity under FRS 100 *Application of Financial Reporting Requirements* and from 1 January 2015, will change its accounting framework to FRS 101 *Reduced Disclosure Framework* (“FRS 101”), which provides disclosure exemptions from EU-adopted International Financial Reporting Standards for qualifying entities. Although there will be changes in the presentation of the financial statements and disclosure under the new framework, there is not expected to be a significant impact on net assets as a result of the transition to FRS 101.

d) Use of estimates and sources of uncertainty

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

During the year, the Company incorporated Funding Valuation Adjustments (“FVA”) into the fair value measurements of over-the-counter (“OTC”) uncollateralised or partially collateralised derivatives, and in collateralised derivatives where the terms of the agreement do not permit the reuse of the collateral received. For further details on the judgements used in determining fair value of certain assets and liabilities, see accounting policy note 1(i).

e) The going concern assumption

The Company’s business activities, together with the factors likely to affect its future development, performance and position, are reflected in the Strategic report on pages 1 to 10.

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

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

f) Functional currency

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

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

g) Foreign currencies

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

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

h) Financial instruments

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

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

More information regarding these classifications is included below:

i) Financial instruments classified as held for trading

Purchases and sales of non-derivative financial instruments classified as held for trading are initially recognised on settlement date at fair value, including regular way securities transactions. For purchases of non-derivative financial instruments classified as held for trading, from the date that the terms are agreed (trade date) until the settlement date, the Company recognises any unrealised fair value in the balance sheet as 'Financial instruments classified as held for trading' with corresponding profit or loss recognised within the profit and loss account in 'Net gains on financial instruments classified as held for trading'.

For sales of non-derivative financial instruments unrealised fair value changes are no longer recognised in the profit and loss account from trade date. Upon settlement date the resulting financial instrument is recognised or de-recognised from the balance sheet.

Derivatives are initially recognised on trade date at fair value. All subsequent changes in fair value are reflected in the profit and loss account in 'Net gains on financial instruments classified as held for trading'.

All changes in fair value, foreign exchange differences, interest and dividends are reflected in the profit and loss account in 'Net gains on financial instruments classified as held for trading'.

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

h) Financial instruments (continued)

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

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

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

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

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

iii) Available-for-sale fixed asset investments

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

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

For equity instruments, dividend income and impairment losses are recognised in the profit and loss account in 'Net gains/(losses) on fixed asset investments in available-for-sale financial assets'. All other gains and losses on equity instruments classified as available-for-sale are recognised in the 'Available-for-sale reserve' within reserves.

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

h) Financial instruments (continued)

iv) Investments in subsidiary undertakings

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

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

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

v) Loans and receivables and financial liabilities at amortised cost

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

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

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

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

i) Fair value of financial instruments

Fair value measurement

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

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

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

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

During the year, the Company incorporated FVA into the fair value measurements of OTC uncollateralised or partially collateralised derivatives, and in collateralised derivatives where the terms of the agreement do not permit the re-use of the collateral received. The Company’s implementation of FVA reflects the inclusion of FVA in the pricing and valuations by the majority of market participants involved in the Company’s principal exit market for these instruments. In general, FVA reflects a market funding risk premium inherent in the noted derivative instruments. The implementation of FVA required a number of important management judgments including:

- Determining when sufficient market evidence exists to indicate that FVA should be incorporated into the fair value measurements;
- Estimating the fair value of funding costs and benefits in the principal exit market; and
- Determining the interaction between Credit Valuation Adjustment (“CVA”) and FVA, given that CVA already reflects credit spreads, which are related to and can impact funding spreads.

The methodology for measuring FVA leverages the Company’s existing credit-related valuation adjustment calculation methodologies, which apply to both assets and liabilities. The incorporation of FVA has resulted in an overall charge of \$273 million against aggregate revenues within ‘Net gains on financial instruments classified as held for trading’ in the profit and loss account in 2014.

Valuation techniques

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

i) Fair value of financial instruments (continued)

Valuation techniques (continued)

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

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

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

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

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

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

i) Fair value of financial instruments (continued)

Valuation process

The Valuation Review Group (“VRG”) within the Financial Control Group (“FCG”) is responsible for the Company’s fair value valuation policies, processes and procedures. VRG is independent of the business units and reports to the Chief Financial Officer of the Morgan Stanley Group (“CFO”), who has final authority over the valuation of the Company’s financial instruments. VRG implements valuation control processes to validate the fair value of the Company’s financial instruments measured at fair value including those derived from pricing models. These control processes are designed to ensure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to ensure that the valuation approach utilised is appropriate and consistently applied and that the assumptions are reasonable.

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

Model Review. VRG, in conjunction with the Market Risk Department and, where appropriate, the Credit Risk Management Department, both of which report to the Chief Risk Officer of the Morgan Stanley Group (“CRO”), independently review valuation models’ theoretical soundness, the appropriateness of the valuation methodology and calibration techniques developed by the business units using observable inputs. Where inputs are not observable, VRG reviews the appropriateness of the proposed valuation methodology to ensure it is consistent with how a market participant would arrive at the unobservable input. The valuation methodologies utilised in the absence of observable inputs may include extrapolation techniques and the use of comparable observable inputs. As part of the review, VRG develops a methodology to independently verify the fair value generated by the business unit’s valuation model. Before trades are executed using new valuation models, those models are required to be independently reviewed. All of the Company’s valuation models are subject to an independent annual VRG review.

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

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

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

i) Fair value of financial instruments (continued)

Valuation process (continued)

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

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

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

Gains and losses on inception

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

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

j) Derecognition of financial assets and liabilities

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

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

k) Impairment of financial assets

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

k) Impairment of financial assets (continued)

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

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

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

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

l) Fees and commissions

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

m) Tangible fixed assets

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

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

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

n) Operating leases

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

o) Taxation

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

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

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

p) Employee compensation plans

i) Equity-settled share-based compensation plans

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

1. ACCOUNTING POLICIES (CONTINUED)

p) Employee compensation plans (continued)

ii) Other deferred compensation plans

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

q) Retirement benefits

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

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

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

r) Cash flow statement

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

2. LOSS OR PROFIT FOR THE YEAR

As permitted by section 408 of the Companies Act 2006, the Company has elected not to present its own profit and loss account for the period. The Company reported a loss after tax of \$616 million for the year ended 31 December 2014 (2013: profit after tax of \$247 million).

MORGAN STANLEY & CO. INTERNATIONAL plc**NOTES TO THE COMPANY FINANCIAL STATEMENTS****Year ended 31 December 2014****3. TANGIBLE FIXED ASSETS**

	Leasehold improvements \$millions	Fixtures, fittings and equipment \$millions	Total \$millions
Cost			
At 1 January 2014	18	14	32
Additions	1	-	1
Disposals	(3)	(1)	(4)
Foreign exchange revaluation	(2)	(1)	(3)
At 31 December 2014	<u>14</u>	<u>12</u>	<u>26</u>
Depreciation			
At 1 January 2014	16	12	28
Charge for the year	2	-	2
Disposals	(3)	(1)	(4)
Foreign exchange revaluation	(2)	-	(2)
At 31 December 2014	<u>13</u>	<u>11</u>	<u>24</u>
Net book value			
At 31 December 2013	<u>2</u>	<u>2</u>	<u>4</u>
At 31 December 2014	<u>1</u>	<u>1</u>	<u>2</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

4. FIXED ASSET INVESTMENTS

Fixed asset investments classified as available-for-sale

Fixed asset investments that are categorised as available-for-sale consist of corporate equities, of which \$2 million are listed investments (2013: \$2 million).

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

	2014	2013
	\$millions	\$millions
At 1 January	56	38
Additions	-	25
Changes in fair value recognised in the 'available-for-sale reserve'	(4)	4
Disposals and other settlements	(14)	(11)
At 31 December	<u>38</u>	<u>56</u>

Fixed asset investments in subsidiary undertakings

	Subsidiary	Total
	undertakings	\$millions
	\$millions	\$millions
Cost		
At 1 January 2014	<u>1,081</u>	<u>1,081</u>
At 31 December 2014	<u>1,081</u>	<u>1,081</u>
Impairment provisions		
At 1 January 2014	(994)	(994)
Provisions made in the year	(2)	(2)
At 31 December 2014	<u>(996)</u>	<u>(996)</u>
Net book value		
At 31 December 2013	<u>87</u>	<u>87</u>
At 31 December 2014	<u>85</u>	<u>85</u>

Details of the significant subsidiary undertakings are provided in note 14 of the consolidated financial statements. A full list of the Company's subsidiary undertakings will be annexed to the Company's next annual return and filed with the Registrar of Companies.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

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

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

	2014		2013	
	Assets	Liabilities	Assets	Liabilities
	\$millions	\$millions	\$millions	\$millions
			Restated⁽¹⁾	Restated⁽¹⁾
Fair value				
Derivative financial instruments (listed and OTC):				
- Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	166,612	163,154	189,554	172,939
- Foreign exchange forward contracts and options	21,199	20,716	12,431	12,555
- Equity securities contracts (including equity swaps, warrants and options)	40,369	42,722	59,606	64,813
- Commodity forwards, options and swaps	6,392	3,981	2,502	2,814
	<u>234,572</u>	<u>230,573</u>	<u>264,093</u>	<u>253,121</u>
Government debt securities	10,881	8,923	8,939	9,178
Corporate and other debt	11,248	2,215	11,559	2,666
Corporate equities	40,583	14,935	47,155	14,479
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total financial instruments classified as held for trading	<u>297,284</u>	<u>256,646</u>	<u>331,746</u>	<u>279,444</u>

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

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

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

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

	2014		2013	
	Assets \$millions	Liabilities \$millions	Assets \$millions	Liabilities \$millions
Fair value				
Prepaid OTC contracts	323	1,698	3,482	2,578
Corporate loans	1,296	-	1,882	-
Issued structured notes	-	1,449	-	1,150
Other financial assets and liabilities	1,741	1,984	2,309	9,218
Total financial instruments designated at fair value through profit or loss	3,360	5,131	7,673	12,946

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

7. DEBTORS

	2014 \$millions	2013 \$millions Restated ⁽¹⁾
Debtors classified within loans and receivables at amortised cost		
Trade debtors:		
- External counterparties	31,480	30,546
- Morgan Stanley Group undertakings	23,918	18,803
Securities purchased under agreements to resell and cash collateral on securities borrowed:		
- External counterparties	43,333	48,875
- Morgan Stanley Group undertakings	36,001	46,666
Other amounts due from Morgan Stanley Group undertakings	2,805	1,910
	137,537	146,800

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

A reconciliation of impairment losses for loans and receivables is as follows:

	2014 \$millions	2013 \$millions
At 1 January	36	50
Charge for the year	15	9
Reversal of impairment losses	(5)	(11)
Amounts written off	(7)	(12)
Foreign exchange revaluation	(1)	-
At 31 December	38	36

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

8. CASH AT BANK

Included within 'Cash at bank' is an amount of \$8,384 million (2013: \$8,267 million) which represents segregated client money, held in accordance with the FCA's Client Money Rules, and an amount of \$718 million (2013: \$358 million) which represents other client money.

9. OTHER ASSETS

	2014	2013
	\$millions	\$millions
Deferred taxation (see note 10)	70	78
Corporation tax recoverable	210	221
Prepayments and accrued income	163	202
	<u>443</u>	<u>501</u>

10. DEFERRED TAX

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

	2014		2013	
	Asset	Liability	Asset	Liability
	\$millions	\$millions	\$millions	\$millions
Accelerated capital allowances	5	-	5	-
Deferred compensation	8	-	8	-
Deferred interest	54	-	55	-
Other timing differences	3	(1)	10	(2)
	<u>70</u>	<u>(1)</u>	<u>78</u>	<u>(2)</u>

MORGAN STANLEY & CO. INTERNATIONAL plc**NOTES TO THE COMPANY FINANCIAL STATEMENTS****Year ended 31 December 2014****10. DEFERRED TAX (CONTINUED)**

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

	2014		2013	
	Asset	Liability	Asset	Liability
	\$millions	\$millions	\$millions	\$millions
At 1 January	78	(2)	75	(3)
Amounts recognised in the profit and loss account:				
- Current year timing differences	-	-	18	-
Amounts recognised in equity through the statement of total recognised gains and losses	(2)	-	(2)	-
Future tax charges on transitional accounting adjustments	-	1	-	1
- Prior year timing differences	(6)	-	(3)	-
Impact of change in UK Corporation tax rate	-	-	(10)	-
At 31 December	<u>70</u>	<u>(1)</u>	<u>78</u>	<u>(2)</u>

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2014

11. FINANCIAL LIABILITIES AT AMORTISED COST

	2014 \$millions	2013 \$millions Restated ⁽¹⁾
Financial liabilities at amortised cost falling due within one year		
Bank loans and overdrafts	15	16
Trade creditors:		
- External counterparties	79,681	64,406
- Morgan Stanley Group undertakings	3,872	9,488
Securities sold under agreements to repurchase and cash collateral on securities loaned:		
- External counterparties	31,007	58,182
- Morgan Stanley Group undertakings	32,441	30,946
Other amounts owing to Morgan Stanley Group undertakings	10,603	11,963
Other financial liabilities	234	1,097
	<u>157,853</u>	<u>176,098</u>
Financial liabilities at amortised cost falling due after more than one year		
Financial instruments issued:		
- Subordinated loans	7,906	7,906
Securities sold under agreements to repurchase and cash collateral on securities loaned:		
- External counterparties	3,067	2,146
Other amounts owing to Morgan Stanley Group undertakings	3,166	3,198
Other financial liabilities	-	1,236
	<u>14,139</u>	<u>14,486</u>
Total financial liabilities at amortised cost	<u>171,992</u>	<u>190,584</u>

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

Included within 'Other amounts owing to Morgan Stanley Group undertakings' falling due within one year are amounts of \$1,172 million (2013: \$7,594 million) representing cash received as collateral security on open trading positions held with other Morgan Stanley Group undertakings.

Total financial liabilities at amortised cost of \$11,072 million (2013: \$11,104 million), included in the above, fall due for payment after five years from the balance sheet date. This consists of subordinated loans of \$7,906 million (2013: \$7,906 million) and other loan amounts owing to Morgan Stanley Group undertakings of \$3,166 million (2013: \$3,198 million). Details of terms relating to the loans are set out in the table below.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2014

11. FINANCIAL LIABILITIES AT AMORTISED COST (CONTINUED)

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

Counterparty	Repayment Date	Interest Rate	2014 \$millions	2013 \$millions
Morgan Stanley UK Financing I LP	31 October 2025	3 months LIBOR ⁽¹⁾ plus 1.475%	7,906	7,906
Great St. Helen Finance Limited	31 May 2020	Canadian dollar proxy related rate ⁽²⁾	922	1,007
Morgan Stanley UK Financing III LP	31 December 2030	US dollar proxy related rate ⁽²⁾	2,244	2,191
			<u>11,072</u>	<u>11,104</u>

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

(2) Proxy interest rates are established by the Morgan Stanley Group Treasury function for all entities within the Morgan Stanley Group and approximate the market rate of interest that Morgan Stanley Group incurs in funding its business.

The amount outstanding under the subordinated loan agreement is repayable at any time at the Company's option, subject to two business days' notice to the lender and at least one month's notice to the PRA, which has the right under the agreement to refuse consent to repayment.

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

12. OTHER CREDITORS

	2014 \$millions	2013 \$millions
Amounts falling due within one year		
Corporation tax payable	58	169
Deferred tax (see note 10)	-	2
Accruals and deferred income	160	183
	<u>218</u>	<u>354</u>
Amounts falling due after more than one year		
Deferred tax (see note 10)	1	-
	<u>1</u>	<u>-</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

13. PROVISIONS FOR LIABILITIES

	Property \$millions	Litigation \$millions	Other \$millions	Total \$millions
At 1 January 2014	3	1	25	29
Additional provisions	2	1	12	15
Provisions utilised	-	(1)	-	(1)
At 31 December 2014	<u>5</u>	<u>1</u>	<u>37</u>	<u>43</u>

Property

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Tangible fixed assets' (note 3).

Litigation matters

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

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

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2014

13. PROVISIONS FOR LIABILITIES (CONTINUED)

Litigation matters (continued)

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. The Company cannot predict with certainty if, how or when such proceedings or investigations will be resolved or what the eventual settlement, fine, penalty or other relief, if any, may be, particularly for proceedings and investigations where the factual record is being developed or contested or where plaintiffs or government entities seek substantial or indeterminate damages, restitution, disgorgement or penalties. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages or other relief, and by addressing novel or unsettled legal questions relevant to the proceedings or investigations in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for a proceeding or investigation. Subject to the foregoing, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of such proceedings and investigations will not have a material adverse effect on the Company's financial statements as a whole, although the outcome of such proceedings or investigations could be material to the Company's operating results and cash flows for a particular period depending on, among other things, the level of the Company's revenues or income for such period.

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

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Company and another Morgan Stanley Group undertaking, styled China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al., which is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a \$275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Company and another Morgan Stanley Group undertaking misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Company and another Morgan Stanley Group undertaking knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately \$228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional \$12 million, punitive damages, equitable relief, fees and costs. On 28 February 2011, the court denied the Company's and another Morgan Stanley Group undertaking's motion to dismiss the complaint.

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2014

13. PROVISIONS FOR LIABILITIES (CONTINUED)

Litigation matters (continued)

On 1 July 2013, the European Commission (“EC”) issued a Statement of Objections (“SO”) addressed to twelve financial firms (including the Company), the International Swaps and Derivatives Association, Inc. and Markit Group Limited and various other Morgan Stanley Group undertakings alleging that, between 2006 and 2009, the recipients breached European Union competition law by taking and refusing to take certain actions in an effort to prevent the development of exchange traded credit default swap (“CDS”) products. The SO indicates that the EC plans to impose remedial measures and fines on the recipients. The Company, other Morgan Stanley Group undertakings and the other recipients filed a response to the SO on 21 January 2014, and attended oral hearings before the EC during the period 12 to 19 May 2014. The Company’s and the other Morgan Stanley Group undertakings’ oral hearing took place on 15 May 2014. The Company and the other Morgan Stanley Group undertakings filed a supplemental response to the SO on 11 July 2014. A Morgan Stanley Group undertaking and others have also responded to an investigation by the Antitrust Division of the United States Department of Justice related to the CDS market.

On 8 May 2014, the California Attorney General’s Office (“CAAG”), which is one of the members of the RMBS Working Group, indicated that it has made certain preliminary conclusions that the Morgan Stanley Group made knowing and material misrepresentations regarding RMBS and that it 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 defenses to them to the CAAG.

Other provisions

Provisions have been raised in relation to certain matters that the Company may be required to settle on behalf of clients or in relation to its own account. The amount of these provisions reflect the most likely estimate within an identified range of possible outcomes.

14. EQUITY

Called up share capital and other equity instruments

	2014	2013
	\$millions	\$millions
Allotted and fully paid:		
9,934,105,148 (2013: 9,934,105,148) ordinary shares of \$1 each	9,934	9,934
17,615,107 ordinary shares of £1 each	30	30
1,500,000,000 Class A non-voting ordinary shares of \$1 each	1,500	1,500
	<u>11,464</u>	<u>11,464</u>
Other equity instruments:		
Additional Tier 1 capital	1,300	-
	<u>12,764</u>	<u>11,464</u>
Voting rights:		
Ordinary shares of \$1 and £1 each	100%	100%
Class A non-voting ordinary shares of \$1 each	Non-voting	Non-voting
Additional Tier 1 capital	Non-voting	-
	<u>100%</u>	<u>100%</u>

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS

Year ended 31 December 2014

14. EQUITY (CONTINUED)

Additional Tier 1 capital

On 15 December 2014, the Company issued Additional Tier 1 capital instruments (the “Instruments”) with a value of \$1,300 million to Morgan Stanley UK Group, a UK incorporated indirect parent of the Company. The Instruments include a trigger mechanism whereby if the Common Equity Tier 1 capital ratio of the Company falls below a pre-determined level, the Company will write-down the outstanding principal amount of the Instruments, together with any accrued but unpaid interest coupon. In this situation, Morgan Stanley UK Group would have no further rights against the Company in respect of the instruments. The Instruments have no defined maturity, are callable at the Company’s discretion after five years from their date of issuance and are subordinated to senior creditors of the Company. The Instruments are not entitled to any participation in the residual net assets of the Company. Coupons on the Instruments are non-cumulative and payable at a fixed rate of 8.75% per annum for five years, resettable every five years thereafter. Payment of the coupon is wholly at the discretion of the Company.

A payment of coupon interest was approved by the Board of Directors on 22 January 2015.

On 24 March 2015, the terms of the Instruments were amended to remove the reset feature and revise the rate payable to a fixed rate of 9% per annum. All other terms remain unchanged.

Equity shares

At 31 December 2014 the total equity instruments of the Company equated to \$12,764 million (2013: \$11,464 million) comprising 9,934,105,148 (2013: 9,934,105,148) ordinary shares of \$1 each, 17,615,107 (2013: 17,615,107) ordinary shares of £1 each, 1,500,000,000 (2013: 1,500,000,000) Class A Non-voting ordinary shares of \$1 each and Additional Tier 1 capital instruments of \$1,300,000,000 (2013: \$nil). All issued shares are fully paid.

On 20 January 2015 1,000,000 ordinary shares of \$1 each were issued at par, to the Company’s immediate parent undertaking for cash consideration.

The holders of the ordinary shares are entitled to receive dividends as declared from time to time and are entitled, on a show of hands, to one vote and, on a poll, one vote per share at meetings of the shareholders of the Company. All shares rank equally with regard to the Company’s residual net assets.

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

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2014

15. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES

	Called up share capital	Additional Tier 1 capital	Share premium account	Currency translation reserve	Available- for-sale reserve	Capital contribution reserve	Capital redemption reserve	Pension reserve	Profit and loss account	Total
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
At 1 January 2013	9,464	-	513	(58)	5	3	1,400	-	1,978	13,305
Total recognised gains and losses	-	-	-	14	-	-	-	-	245	259
Remeasurement of defined benefit liability	-	-	-	-	-	-	-	-	2	2
Dividends	-	-	-	-	-	-	-	-	(89)	(89)
Ordinary shares issued	3,050	-	-	-	-	-	-	-	-	3,050
Preference shares repurchased	(1,050)	-	-	-	-	-	-	-	-	(1,050)
At 1 January 2014	11,464	-	513	(44)	5	3	1,400	-	2,136	15,477
Total recognised gains and losses	-	-	-	(44)	1	-	-	-	(616)	(659)
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	-	-	-	-	-	-	-	-	(2)	(2)
Remeasurement of defined benefit liability	-	-	-	-	-	-	-	1	-	1
Additional Tier 1 capital (see note 14)	-	1,300	-	-	-	-	-	-	-	1,300
At 31 December 2014	11,464	1,300	513	(88)	6	3	1,400	1	1,518	16,117

Reserves

Share premium

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

Currency translation reserve

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

Available-for-sale reserve

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

Capital contribution reserve

The 'Capital contribution reserve' comprises of contributions of capital received from the Company's parent company.

Capital redemption reserve

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

Pension reserve

The 'Pension reserve' comprises cumulative actuarial gains or losses on the scheme assets and obligations net of current tax and the impact of the asset surplus ceiling (see note 18).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2014

16. COMMITMENTS AND CONTINGENCIES

During the next year, the Company is committed to pay \$5 million (2013: \$6 million) in respect of operating leases as follows:

	Land and buildings	
	2014	2013
	\$millions	\$millions
Annual commitments under operating leases expiring:		
- Within one year	1	2
- In two to five years	2	2
- After more than five years	2	2
	<u>5</u>	<u>6</u>

17. EMPLOYEE COMPENSATION PLANS

Morgan Stanley maintains various deferred compensation plans for the benefit of its employees. The two principal forms of deferred compensation are granted under stock based compensation and deferred cash based compensation plans.

Equity-settled share-based compensation plans

- **Restricted stock units**

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

During the year, Morgan Stanley granted 297,951 units (2013: 450,584 units) of restricted stock units to employees of the Company with a weighted average fair value per unit of \$32.57 (2013: \$22.52), based on the market value of Morgan Stanley shares at grant date.

- **Stock options**

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

There were no options granted during the year (2013: none).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2014

17. EMPLOYEE COMPENSATION PLANS (CONTINUED)

Equity-settled share-based compensation plans (continued)

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

	2014		2013	
	Number of options '000s	Weighted average exercise price \$	Number of options '000s	Weighted average exercise price \$
Options outstanding at 1 January	42	55.88	61	52.01
Expired during the year	(20)	47.19	(19)	43.41
Options outstanding and exercisable at 31 December	<u>22</u>	<u>63.93</u>	<u>42</u>	<u>55.88</u>

There were no options exercised during the year (2013: none).

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

Range of exercise prices	2014			2013		
	Number of options '000s	Weighted average exercise price \$	Weighted average remaining life in years	Number of options '000s	Weighted average exercise price \$	Weighted average remaining life in years
\$40.00 - \$49.99	3	43.15	-	23	46.73	0.1
\$60.00 - \$69.99	19	66.73	2.0	19	66.73	3.0
Total	<u>22</u>	<u>63.93</u>	<u>1.7</u>	<u>42</u>	<u>55.88</u>	<u>1.4</u>

Deferred cash-based compensation plans

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

Awards with a value of \$10 million (2013: \$10 million) have been granted to employees during the year and an expense of \$14 million (2013: \$13 million) has been recognised within 'Direct Staff costs' in 'Other expense' in the profit and loss account in relation to current and previous years' awards. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the balance sheet, was \$12 million (2013: \$8 million).

The Company economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation schemes is \$nil (2013: \$nil) and recognised within 'Financial liabilities classified as held for trading' is \$2 million (2013: \$2 million). The related profit or loss recorded within 'Net gains/(losses) on financial instruments classified as held for trading' for the year is \$nil (2013: \$nil).

MORGAN STANLEY & CO. INTERNATIONAL plc

NOTES TO THE COMPANY FINANCIAL STATEMENTS Year ended 31 December 2014

18. RETIREMENT BENEFITS

Defined contribution plans

The Company operates two Morgan Stanley defined contribution plans, which require contributions to be made to funds held separately from the assets of the Company, under the control of a trustee.

The defined contribution plans are as follows:

- Morgan Stanley Flexible Company Pension Plan (Amsterdam)
- MSII Offshore Retirement Benefit Plan IV, Dubai Section

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

The defined contribution pension charge recognised within 'Staff costs' in 'Other expense' in the profit and loss account was \$3 million for the year (2013: \$2 million) of which \$nil was accrued at 31 December 2014 (2013: \$nil).

Defined benefit plans

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

The defined benefit plans are as follows:

- Morgan Stanley & Co International plc Paris Branch IFC (Indemnités de Fin de Carrière)
- Personalvorsorgestiftung der Bank Morgan Stanley AG Plan
- Morgan Stanley Dubai End of Service Gratuity

A net liability of \$2 million (2013: \$2 million) is recognised in the balance sheet in respect of these plans.

19. RELATED PARTY TRANSACTIONS

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

20. PARENT UNDERTAKINGS

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

The Company's immediate parent undertaking Morgan Stanley Investments (UK) is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.

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