

**Registration No 2068222**  
**Registered Office:**  
**25 Cabot Square**  
**Canary Wharf**  
**London E14 4QA**

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**Half-yearly financial report**

**30 June 2010**

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# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT

The Directors present their interim management report and the condensed consolidated financial statements of Morgan Stanley and Co. International plc (the "Company") and all of its subsidiary and associated undertakings (together the "Group"), for the six months ended 30 June 2010. This interim report has been prepared for the Group as a whole and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiary and associated undertakings when viewed as a whole.

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

### RESULTS AND DIVIDENDS

The Group's profit for the six months to 30 June 2010, after tax, is \$351 million (30 June 2009: \$761 million). During the six month period, \$nil dividends were paid on the ordinary shares (30 June 2009: \$nil).

### PRINCIPAL ACTIVITY

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions. There have not been any significant changes in the Group's principal activities in the period under review and no significant change in the Group's principal business is expected. The Company is authorised and regulated by the Financial Services Authority ("FSA").

The Company operates branches in the Dubai International Financial Centre, France, Greece, Korea, the Netherlands, New Zealand, the Qatar Financial Centre and Switzerland (opened on 8 February 2010).

The Company'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".

### BUSINESS REVIEW

The modest economic recovery initiated in 2009 continues to be evident in the wider economy, although the Group continues to be impacted by challenging market conditions. These conditions present difficulties and uncertainty for the business outlook which may adversely impact the financial performance of the Group in the future. The condensed consolidated income statement for the period is set out on page 6. Comparing the six months to 30 June 2010 to the six months to 30 June 2009, the Group's profit for the period decreased by \$410 million to \$351 million, a decrease of 54%. The Group's revenues declined in the major business areas, particularly in Fixed Income sales and trading and Equity sales and trading, compared to the six months ended 30 June 2009, even after taking into account the positive impact of the widening of own credit spreads on certain of the Group's financial instruments that are accounted for at fair value. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. In the six months ended 30 June 2009, these policies reduced the impact of difficult market conditions on the Group's performance. As discussed more fully in note 35 of the Group's report and financial statements for the year ended 31 December 2009, those policies were refined in the latter half of 2009, and have had a modest negative impact on the comparative performance of the Group in the six months to 30 June 2010.

The Group's net interest expense has reduced by 42% to \$300 million. Within this, interest income and interest expense have reduced by 26% and 29% respectively. The decrease was driven by significant reductions in interest rates. The Group's other expenses have increased by 9% due to increased staff costs as a result of the \$321 million charge in the period relating to the UK bank payroll tax, partially offset by a decrease in other staff costs.

The condensed statement of financial position presented on page 10 of the financial statements reflects increases in the Group's total assets and total liabilities. Both have increased by 13% as at 30 June 2010 when compared to 31 December 2009. Trade receivables and trade payables have increased by \$25,503 million and \$22,798 million respectively, driven by an increase in trading activity at the period end when compared to the prior year end. Financial assets classified as held for trading and financial liabilities classified as held for trading have increased by \$16,569 million and \$21,290 million respectively. These movements are primarily due to increases in the Group's derivative instruments, driven by market volatility in the period. Other notable increases occurred in reverse repurchase agreements (\$14,237 million) and repurchase agreements (\$16,171 million) reflecting an increase in activity in these products during the period. These increases have been partially offset by reductions in other receivables of \$4,698 million and in other payables of \$9,047 million due to reductions in balances with other Morgan Stanley Group undertakings.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT (CONTINUED)

### Securitisation exposures

The Group has exposure to mortgage-related risk. As at 30 June 2010 the amount recognised on the Group statement of financial position in relation to residential mortgage backed securities ("RMBS") was \$855 million (31 December 2009: \$468 million). The increase in RMBS is mainly due to the purchase of retained interests in securitisations from other Morgan Stanley Group undertakings. The Group continues to have exposure to non sub-prime commercial mortgage-backed securities ("CMBS") arising from its trading activities. As at 30 June 2010 the amount recognised on the statement of financial position in relation to CMBS was \$692 million (31 December 2009: \$610 million).

The Group is involved with various entities in the normal course of business that may be deemed to be special purpose entities ("SPEs"). The Group's interests in SPEs include debt and equity interests and derivative instruments, and these interests primarily arise from trading activity and structured transactions. Consolidation of SPEs is determined in accordance with the Group's accounting policies. As at 30 June 2010 the total assets of SPEs in which the Group has an interest, but which are not consolidated by the Group, are \$633 million (31 December 2009: \$3,669 million) and the Group's maximum exposure to loss relating to such SPEs is \$216 million (31 December 2009: \$43 million). The Group's consolidated statement of financial position includes \$4,691 million (31 December 2009: \$3,474 million) of assets arising from consolidated SPEs. The Group's maximum exposure to loss relating to these assets is \$2,030 million (31 December 2009: \$1,813 million).

### Bank Payroll Tax

On 8 April 2010 the UK government enacted legislation as part of the 2010 Finance Act imposing a bank payroll tax. The tax applies to discretionary bonuses over a certain amount awarded to certain employees within scope ("Banking Employees") in the period from 9 December 2009 to 5 April 2010. The liability for the tax will be that of the entity that benefits from the services of the Banking Employees, rather than the employing entity. During the first half of 2010 the Group recognised a charge of \$321 million in staff expenses relating to this tax.

### Risk management

Risk is an inherent part of both Morgan Stanley's and the Group's business activity and is managed by the Group within the context of the broader Morgan Stanley Group. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities on a global basis, in accordance with defined policies and procedures and in consideration of the individual legal entities. The Group's own risk management policies and procedures are consistent with those of the Morgan Stanley Group.

#### *Market risk*

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

The Group is managed within the Morgan Stanley Group's global framework. The market risk management policies and procedures of the Group are consistent with those of Morgan Stanley Group, including reporting of material risks identified to appropriate key management personnel of the Group. Sound market risk management is an integral part of the Group's culture. The various business units and trading desks are responsible for ensuring that market risk exposures are well-managed and prudent. The market risk department is responsible for ensuring transparency of material market risks, monitoring compliance with established limits, and escalating risk concentrations to appropriate senior management. To execute these responsibilities, the Morgan Stanley Group monitors its market risk against limits on aggregate risk exposures, performs a variety of risk analyses and maintains the Value at Risk ("VaR") system. A variety of limits are designed to control price and liquidity risk. Market risk is monitored through various measures: statistically (using VaR and related analytical measures); by measures of position sensitivity; and through routine stress testing and scenario analyses. The material risks identified by these processes are summarised and reported to senior management.

The Group's trading VaR at 30 June 2010 was \$65 million compared with \$44 million at 31 December 2009. Excluding the counterparty portfolio, which has been reclassified from Non-Trading book to Trading book at the beginning of 2010, the Group's trading VaR at 30 June 2010 would have been \$55 million. The increase excluding the counterparty portfolio has been driven primarily by an increase in interest rate and credit spread risk combined with increased equity price risk.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT (CONTINUED)

### **Risk management (continued)**

#### *Credit risk*

Credit risk refers to the risk of loss arising from a borrower or counterparty default when a borrower, counterparty or obligor does not meet its obligations. The Morgan Stanley Group manages credit risk exposure on a global basis as well as giving consideration to each individual legal entity. It does this by ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit, escalating risk concentrations to appropriate senior management and mitigating credit risk through the use of collateral and other arrangements.

#### *Liquidity and funding risk*

Liquidity and funding risk refers to the risk that the Group will be unable to meet its funding obligations in a timely manner. Liquidity risk stems from the potential risk that the Group will be unable to obtain necessary funding through borrowing money at favourable interest rates or maturity terms, or selling assets in a timely manner and at a reasonable price.

The Morgan Stanley Group's senior management establishes the overall liquidity and capital policies of the Morgan Stanley Group. The Morgan Stanley Group's liquidity and funding risk management policies are designed to mitigate the potential risk that the Morgan Stanley Group and the Group may be unable to access adequate financing to service its financial obligations without material adverse franchise or business impact. The key objectives of the liquidity and funding risk management framework are to support the successful execution of the Morgan Stanley Group's and the Group's business strategies while ensuring sufficient liquidity through the business cycle and during periods of stressed market conditions. The Morgan Stanley Group has established regional committees to oversee the activities of its subsidiaries from a regional perspective.

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

This liquidity and funding risk management framework continues to provide sufficient liquidity to the Morgan Stanley Group and to the Group, and the Group's capital and liquidity position is satisfactory.

### **Going Concern**

Taking all of the above factors into consideration, the Directors have no reason to believe that the Group will not 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 half-yearly report and condensed financial statements.

By order of the Board on 26 August 2010



Director

G G LYNCH

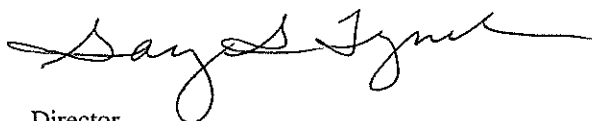
# MORGAN STANLEY & CO. INTERNATIONAL plc

## RESPONSIBILITY STATEMENT

We confirm to the best of our knowledge that:

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

By order of the Board on 26 August 2010



Director

G G LYNCH

Board of Directors:

C D S Bryce  
W A Chammah (Chairman)  
G G Lynch  
F R Petitgas  
C E Woodman

# **INDEPENDENT REVIEW REPORT TO MORGAN STANLEY & CO. INTERNATIONAL plc**

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2010 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated statement of changes in equity, the condensed consolidated statement of cash flows, the condensed consolidated statement of financial position, and related notes 1 to 8. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

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

## **Directors' responsibilities**

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

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

## **Our responsibility**

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

## **Scope of review**

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

## **Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2010 is not prepared, in all material aspects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

*Deloitte LLP*

## **Deloitte LLP**

Chartered Accountants and Statutory Auditors

London

26 August 2010

Notes:

- a. Neither an audit nor a review provides assurance on the maintenance of information presented on a website, including controls used to achieve this, and in particular whether any changes may have occurred to the financial statements since first published. These matters are the responsibility of the Directors but no control procedures can provide absolute assurance in this area.
- b. Legislation in the United Kingdom governing the preparation and dissemination of financial information differs from legislation in other jurisdictions.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED INCOME STATEMENT**

**Six months ended 30 June 2010**

	Note	Six months ended 30 June 2010 \$millions (unaudited)	Six months ended 30 June 2009 \$millions (unaudited)
Net gains on financial instruments classified as held for trading		2,442	3,723
Net gains / (losses) on financial instruments designated at fair value through profit or loss		106	(517)
Net gains on available-for-sale financial assets		57	-
Interest income		1,685	2,288
Interest expense		(1,985)	(2,804)
Other income		93	95
Other expense		(1,793)	(1,647)
<b>PROFIT BEFORE INCOME TAX</b>		<b>605</b>	<b>1,138</b>
Income tax expense	2	(254)	(377)
<b>PROFIT FOR THE PERIOD</b>		<b>351</b>	<b>761</b>
Attributable to:			
Equity holders of the Company		350	759
Minority interest		1	2
<b>PROFIT FOR THE PERIOD</b>		<b>351</b>	<b>761</b>

All operations were continuing in the current and prior period.

The notes on pages 11 to 40 form an integral part of the condensed financial statements.



**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**  
**Six months ended 30 June 2010**

	Six months ended 30 June 2010 \$millions (unaudited)	Six months ended 30 June 2009 \$millions (unaudited)
<b>PROFIT FOR THE PERIOD</b>	<u>351</u>	<u>761</u>
<b>OTHER COMPREHENSIVE INCOME</b>		
Foreign currency translation differences for foreign operations	(9)	41
Fair value reserve:		
<i>Available-for-sale financial assets:</i>		
Net change in fair value recognised directly in equity	(1)	(10)
Net current and deferred tax on items taken directly to equity	-	3
<b>OTHER COMPREHENSIVE INCOME AFTER INCOME TAX</b>	<u>(10)</u>	<u>34</u>
<b>TOTAL COMPREHENSIVE INCOME</b>	<u><u>341</u></u>	<u><u>795</u></u>
<b>Attributable to:</b>		
Equity holders of the Company	351	793
Minority interest	(10)	2
<b>TOTAL COMPREHENSIVE INCOME</b>	<u><u>341</u></u>	<u><u>795</u></u>

The notes on pages 11 to 40 form an integral part of the condensed financial statements.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY**  
**Six months ended 30 June 2010**

	Share capital	Share premium	Currency translation reserve	Capital redemption reserve	Capital contribution reserve	Fair value reserve	Retained earnings	Equity attributable to equity holders	Minority interest	Total equity
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Balance at 1 January 2009	4,328	513	(22)	149	3	2	3,098	8,071	67	8,138
Profit for the period	-	-	-	-	-	-	759	759	2	761
Foreign currency translation differences on foreign operations	-	-	41	-	-	-	-	41	-	41
Net change in fair value recognised directly in equity	-	-	-	-	-	(10)	-	(10)	-	(10)
Net deferred tax on items taken directly to equity	-	-	-	-	-	3	-	3	-	3
Share-based payments	-	-	-	-	-	-	1	1	-	1
Net Capital contribution	-	-	-	-	-	-	50	50	-	50
Balance at 30 June 2009	4,328	513	19	149	3	(5)	3,908	8,915	69	8,984
Balance at 1 January 2010	3,078	513	(62)	1,399	3	(3)	1,815	6,743	74	6,817
Profit for the period	-	-	-	-	-	-	350	350	1	351
Foreign currency translation differences on foreign operations	-	-	2	-	-	-	-	2	(11)	(9)
Net change in fair value recognised directly in equity	-	-	-	-	-	(1)	-	(1)	-	(1)
Balance at 30 June 2010	3,078	513	(60)	1,399	3	(4)	2,165	7,094	64	7,158

The notes on pages 11 to 40 form an integral part of the condensed financial statements.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

**As at 30 June 2010**

	Note	Six months ended 30 June 2010 \$millions (unaudited)	Six months ended 30 June 2009 \$millions (unaudited)
<b>NET CASH FLOWS FROM / (USED IN) OPERATING ACTIVITIES</b>	3(b)	1,175	(7,302)
<b>INVESTING ACTIVITIES</b>			
Purchase of property, plant and equipment		-	(1)
Proceeds from sale of property, plant and equipment		1	2
Purchase of available-for-sale investments		(2)	(4)
Proceeds from sale of available-for-sale financial assets		2	19
Dividends from available-for-sale financial assets		-	-
Disposal of associate		-	3
Acquisition of subsidiaries, net of cash acquired		-	(2)
Net capital contribution arising from Morgan Stanley Smith Barney joint venture		-	50
<b>NET CASH FLOWS FROM INVESTING ACTIVITIES</b>		<u>1</u>	<u>67</u>
<b>FINANCING ACTIVITIES</b>			
Interest paid on subordinated loans		<u>(69)</u>	<u>(190)</u>
<b>NET CASH FLOWS USED IN FINANCING ACTIVITIES</b>		<u>(69)</u>	<u>(190)</u>
<b>NET INCREASE / (DECREASE) IN CASH AND CASH EQUIVALENTS</b>		1,107	(7,425)
Currency translation differences on foreign currency cash balances		(598)	197
<b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD</b>		13,454	19,537
<b>CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD</b>	3(a)	<u>13,963</u>	<u>12,309</u>

The notes on pages 11 to 40 form an integral part of the condensed financial statements.

**CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION**  
**As at 30 June 2010**

	30 June 2010 \$millions (unaudited)	31 December 2009 \$millions
<b>ASSETS</b>		
Loans and receivables:		
Cash at bank	14,166	13,580
Securities borrowed	29,073	25,394
Reverse repurchase agreements	97,568	83,331
Trade receivables	77,145	51,642
Other receivables	11,486	16,184
	<u>229,438</u>	<u>190,131</u>
Financial assets classified as held for trading (of which approximately \$47,912 million (2009: \$54,185 million) were pledged to various parties)	260,642	244,073
Financial assets designated at fair value through profit or loss	2,589	1,907
Available-for-sale financial assets	44	43
Current tax	461	558
Deferred tax assets	36	47
Prepayments and accrued income	56	19
Property, plant and equipment	13	16
Associates and joint ventures	7	7
<b>TOTAL ASSETS</b>	<u>493,286</u>	<u>436,801</u>
<b>LIABILITIES AND EQUITY</b>		
Financial liabilities at amortised cost:		
Bank loans and overdrafts	203	126
Securities loaned	47,529	44,306
Repurchase agreements	81,937	65,766
Trade payables	87,355	64,557
Other payables	24,701	33,748
Subordinated loans	8,550	8,550
Preference shares	786	786
	<u>251,061</u>	<u>217,839</u>
Financial liabilities classified as held for trading	224,845	203,555
Financial liabilities designated at fair value through profit or loss	9,406	7,879
Provisions	21	22
Current tax	500	381
Deferred tax liabilities	-	7
Accruals and deferred income	291	297
Retirement benefit obligations	4	4
<b>TOTAL LIABILITIES</b>	<u>486,128</u>	<u>429,984</u>
<b>EQUITY ATTRIBUTABLE TO SHAREHOLDERS</b>		
Share capital	3,078	3,078
Share premium account	513	513
Other reserves	1,338	1,337
Retained earnings	2,165	1,815
	<u>7,094</u>	<u>6,743</u>
Minority interest	64	74
<b>TOTAL EQUITY</b>	<u>7,158</u>	<u>6,817</u>
<b>TOTAL LIABILITIES AND EQUITY</b>	<u>493,286</u>	<u>436,801</u>

The notes on pages 11 to 40 form an integral part of the condensed financial statements.

**MORGAN STANLEY & CO. INTERNATIONAL plc**  
**NOTES TO THE CONDENSED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2010**

**1. BASIS OF PREPARATION**

**i General information**

The information in this interim report does not constitute statutory accounts within the meaning of Section 434 of the Companies Act 2006.

The information for the period ended 31 December 2009 does not constitute statutory accounts as defined in section 434 of the Companies Act 2006. A copy of the statutory accounts for that year has been delivered to the Registrar of Companies. The auditors' report on those accounts, which was unqualified, did not draw attention to any matters by way of emphasis and did not contain statements under section 237(2) or (3) of the Companies Act 2006.

**ii Accounting policies**

The Group prepares its annual financial statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU"). The condensed financial statements have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority and in accordance with International Accounting Standard ("IAS") 34 '*Interim Financial Reporting*', as adopted by the EU.

In preparing these condensed financial statements the Group has applied consistently the accounting policies and methods of computation used in the Group's financial statements for the period ended 31 December 2009.

**New standards and interpretations adopted during the period**

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

IFRS 3 'Business combinations'. This was revised by the IASB in January 2008 for prospective application in accounting periods beginning on or after 1 July 2009. The revised standard was endorsed by the EU in June 2009.

IAS 27 'Consolidated and separate financial statements' was revised by the IASB in January 2008 for application in accounting periods beginning on or after 1 July 2009. The revised standard was endorsed by the EU in June 2009.

As part of the April 2009 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 2 'Share-based Payment' and 'IAS 38 'Intangible Assets' (for application in accounting periods beginning on or after 1 July 2009); IFRS 8 'Operating Segments', IAS 1 'Presentation of Financial Statements', IAS 7 'Statement of Cash Flows', IAS 17 'Leases', IAS 18 'Revenue', IAS 36 'Impairment of Assets' and IAS 39 'Financial Instruments: Recognition and Measurement' (for application in accounting periods beginning on or after 1 January 2010). These Annual Improvements were endorsed by the EU in March 2010.

**MORGAN STANLEY & CO. INTERNATIONAL plc**  
**NOTES TO THE CONDENSED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2010**

**1. BASIS OF PREPARATION (CONTINUED)**

**ii Accounting policies (continued)**

**New standards and interpretations not yet adopted**

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

New standards and interpretations that do not impact the current period:

IFRS 9 Financial instruments was issued by the IASB in November 2009 for retrospective application in accounting periods beginning on or after 1 January 2013. Although there are expected to be significant changes to the presentation of financial instruments by the Group, there is not expected to be a significant impact on net assets.

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

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

As part of the May 2010 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 3 'Business combinations' and IAS 27 'Consolidated and separate financial statements' (for application in accounting periods beginning on or after 1 July 2010), and IFRS 7 'Financial instruments: disclosures' and IAS 1 'Presentation of Financial Statements' (for application in accounting periods beginning on or after 1 January 2011).

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

**iii Use of estimates and sources of uncertainty**

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

**2. TAX EXPENSE**

The Group's tax expense for the period has been accrued based on the expected tax rate of 42% for the period to 30 June 2010 (30 June 2009: 33.1%). This takes into account current expectations concerning allocation of group relief within the Morgan Stanley UK tax group and prevailing tax rates in the jurisdictions in which the Group operates, as well as the impact of the non-deductible UK bank payroll tax.

**MORGAN STANLEY & CO. INTERNATIONAL plc**  
**NOTES TO THE CONDENSED FINANCIAL STATEMENTS**

**Six months ended 30 June 2010**

**3. ADDITIONAL CASH FLOW INFORMATION**

**a. Cash and cash equivalents**

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

	<b>30 June 2010 \$millions</b>	<b>30 June 2009 \$millions</b>
Cash at bank	14,166	12,489
Bank loans and overdrafts	(203)	(180)
	<u>13,963</u>	<u>12,309</u>

**b. Reconciliation of cash flows from / (used in) operating activities**

	<b>Six months ended 30 June 2010 \$millions</b>	<b>Six months ended 30 June 2009 \$millions</b>
Profit for the period	351	761
<i>Adjustments for:</i>		
Depreciation on property, plant and equipment	2	1
Net gains on available for sale financial assets	(57)	-
Interest income	(1,685)	(2,288)
Interest expense	1,985	2,804
Income tax expense	254	377
Profit before changes in operating assets and liabilities	<u>850</u>	<u>1,655</u>
Change in operating assets		
Net increase in loans and receivables	(38,194)	(13,550)
Net (increase) / decrease in financial assets classified as held for trading	(16,569)	21,075
Net increase in financial assets designated at fair value through profit or loss	(682)	(123)
	<u>(55,445)</u>	<u>7,402</u>
Change in operating liabilities		
Net increase in financial liabilities at amortised cost	32,898	1,178
Net increase / (decrease) in financial liabilities classified as held for trading	21,290	(17,437)
Net increase in financial liabilities designated at fair value through profit or loss	1,527	298
Net increase in other liabilities	-	3
Net decrease in provisions	(1)	-
	<u>55,714</u>	<u>(15,958)</u>
Effect of foreign exchange movements	587	(176)
<b>Cash from / (used in) operating activities</b>	<u>1,706</u>	<u>(7,077)</u>
Interest received	1,178	2,185
Interest paid	(1,675)	(2,409)
Income tax paid	(34)	(1)
<b>Net cash flows from / (used in) operating activities</b>	<u>1,175</u>	<u>(7,302)</u>

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**4. SEGMENT REPORTING**

Segment information is presented in respect of the Group's business and geographical segments. Both the primary format, business segments, and geographical segments are based on the Group's management and internal reporting structure. Segmentation and measurement of segment profit and loss for the six months ended 30 June 2010, has been prepared on the same basis as that for the most recent annual financial statements.

**Business segment**

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 services to corporations, governments, financial institutions and individual investors including sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange.

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

<b>Condensed consolidated income statement information Six months ended 30 June 2010</b>	<b>Institutional Securities \$millions</b>	<b>Other \$millions</b>	<b>Total \$millions</b>
Net gains on financial instruments classified as held for trading	2,443	(1)	2,442
Net gains on financial instruments designated at fair value through profit or loss	106	-	106
Net gains on available-for-sale financial assets	57	-	57
Net interest	(310)	10	(300)
Other income	100	(7)	93
<b>External revenues net of interest expense</b>	<b>2,396</b>	<b>2</b>	<b>2,398</b>
Other expense	(1,751)	(42)	(1,793)
<b>Profit / (loss) before tax</b>	<b>645</b>	<b>(40)</b>	<b>605</b>
Income tax (expense) / credit	(271)	17	(254)
<b>Profit / (loss) for the period</b>	<b>374</b>	<b>(23)</b>	<b>351</b>



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**4. SEGMENT REPORTING (CONTINUED)**

**Business segment (continued)**

<b>Condensed consolidated statement of financial position information</b> <b>As at 30 June 2010</b>	<b>Institutional Securities</b> <b>\$millions</b>	<b>Other</b> <b>\$millions</b>	<b>Total</b> <b>\$millions</b>
Segment assets	488,636	4,643	493,279
Associate and joint venture	7	-	7
<b>Total assets</b>	<b>488,643</b>	<b>4,643</b>	<b>493,286</b>
Segment liabilities	482,638	3,490	486,128
<b>Total liabilities</b>	<b>482,638</b>	<b>3,490</b>	<b>486,128</b>
<b>Other segment information</b>			
Property, plant and equipment capital expenditure	-	-	-
Depreciation on property, plant and equipment	2	-	2

<b>Condensed consolidated income statement information</b> <b>Six months ended 30 June 2009</b>	<b>Institutional Securities</b> <b>\$millions</b>	<b>Other</b> <b>\$millions</b>	<b>Total</b> <b>\$millions</b>
Net gains on financial instruments classified as held for trading	3,723	-	3,723
Net gains on financial instruments designated at fair value through profit or loss	(517)	-	(517)
Net gains on available-for-sale financial assets	-	-	-
Net interest	(536)	20	(516)
Other income	62	33	95
<b>External revenues net of interest expense</b>	<b>2,732</b>	<b>53</b>	<b>2,785</b>
Other expense	(1,542)	(105)	(1,647)
<b>Profit / (loss) before tax</b>	<b>1,190</b>	<b>(52)</b>	<b>1,138</b>
Income tax (expense) / credit	(392)	15	(377)
<b>Profit / (loss) for the period</b>	<b>798</b>	<b>(37)</b>	<b>761</b>

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**4. SEGMENT REPORTING (CONTINUED)**

**Business segment (continued)**

<b>Consolidated statement of financial position information</b> <b>As at 31 December 2009</b>	<b>Institutional Securities</b> <b>\$millions</b>	<b>Other</b> <b>\$millions</b>	<b>Total</b> <b>\$millions</b>
Segment assets	432,087	4,707	436,794
Associate and joint venture	7	-	7
<b>Total assets</b>	<b>432,094</b>	<b>4,707</b>	<b>436,801</b>
Segment liabilities	426,216	3,768	429,984
<b>Total liabilities</b>	<b>426,216</b>	<b>3,768</b>	<b>429,984</b>
<b>Other segment information</b>			
Property, plant and equipment capital expenditure	1	-	1
Depreciation on property, plant and equipment	7	-	7

**Geographical Segments**

The Group operates in three geographic regions as listed below:

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

The following table presents selected consolidated income statement and 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.

<b>Geographical segments</b>	<b>EMEA</b>		<b>Americas</b>		<b>Asia</b>		<b>Total</b>	
	<b>30 June 2010</b>	<b>30 June 2009</b>	<b>30 June 2010</b>	<b>30 June 2009</b>	<b>30 June 2010</b>	<b>30 June 2009</b>	<b>30 June 2010</b>	<b>30 June 2009</b>
	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>
External revenues net of interest expense	2,352	2,496	48	189	(2)	100	2,398	2,785
Profit/(loss) before tax	646	1,218	25	(138)	(66)	58	605	1,138
	<b>30 June 2010</b>	<b>31 Dec 2009</b>	<b>30 June 2010</b>	<b>31 Dec 2009</b>	<b>30 June 2010</b>	<b>31 Dec 2009</b>	<b>30 June 2010</b>	<b>31 Dec 2009</b>
	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>
Total assets	378,792	340,856	73,813	54,647	40,681	41,298	493,286	436,801

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**5. FINANCIAL RISK MANAGEMENT**

**Risk management procedures**

Risk is an inherent part of both Morgan Stanley's and the Group's business activity and is managed by the Group within the context of the broader Morgan Stanley Group. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities in accordance with defined policies and procedures. The Group's own risk management policies and procedures are consistent with those of the Morgan Stanley Group.

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

**Credit risk**

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

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

The Group is exposed primarily to significant single-name credit risk, requiring credit analysis of specific counterparties, both initially and on an ongoing basis. Credit risk management takes place at the transaction, counterparty and portfolio levels. In order to help protect the Group from losses resulting from its business activities, the Group analyses all material lending and derivative transactions and ensures that the creditworthiness of the Group's counterparties and borrowers is reviewed regularly and that credit exposure is actively monitored and managed. The Group assigns obligor credit ratings to its counterparties and borrowers which are intended to assess a counterparty's probability of default and are derived using methodologies generally consistent with those used by external rating agencies. For lending transactions, the Group evaluates the relative position of its particular exposure in the borrower's capital structure and relative recovery prospects. Where applicable, the Group also considers collateral arrangements and other structural elements of the particular transaction. The Group has credit guidelines that limit potential credit exposure to any one borrower or counterparty and to aggregates of borrowers or counterparties; these limits are monitored and credit exposures relative to these limits are reported to key management personnel.

As well as assessing and monitoring its credit exposure and risk at the individual counterparty level, the Group also reviews its credit exposure and risk to geographic regions. As at 30 June 2010 and 31 December 2009, credit exposure was concentrated in North America and Western European countries. In addition, the Group pays particular attention to smaller exposures in emerging markets given their higher risk profile. Country ceiling ratings are derived using methodologies generally consistent with those employed by external rating agencies.

The Group also reviews its credit exposure and risk to types of customers. At 30 June 2010 and 31 December 2009, the Group's material credit exposure was to corporate entities (including financial institutions) and sovereign-related entities.

*Collateral and other credit enhancements*

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

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Credit risk (continued)**

*Reverse repurchase agreements and securities borrowed*

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

*Derivatives*

The Group may seek to mitigate credit risk from its derivatives transactions in multiple ways. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size and maturity. The Group actively hedges its credit exposure arising from derivatives through various financial instruments which may include single name, portfolio and structured credit derivatives. Additionally, the Group may enter into master netting agreements and collateral arrangements with counterparties. These master netting agreements and collateral arrangements may provide the Group with the ability to offset a counterparty's rights and obligations, to request additional collateral when necessary and to liquidate the collateral in the event of counterparty default. The Group monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral in accordance with collateral arrangements when deemed necessary.

*Exposure to credit risk*

The maximum exposure to credit risk of the Group as at 30 June 2010 and 31 December 2009 is disclosed below, based on the carrying amount of the financial assets the Group believes is subject to credit risk, without taking account of any collateral held or any other credit enhancement. Exposure arising from financial instruments not recognised on the consolidated statement of financial position is measured as the maximum amount that the Group could have to pay, which may be significantly greater than the amount that would be recognised as a liability. This table does not include receivables arising from pending securities transactions with market counterparties. The "unrated" balance represents the pool of counterparties that individually generate no material credit exposure. This pool is highly diversified, monitored and subject to limits.

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

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Credit risk (continued)**

*Exposure to credit risk by class*

<b>Class</b>	<b>Gross credit exposure 30 June 2010 \$millions</b>	<b>Gross credit exposure 31 December 2009 \$millions</b>
Loans and receivables:		
Cash at bank	14,166	13,580
Securities borrowed	29,073	25,394
Reverse repurchase agreements	97,568	83,331
Trade receivables	38,927	34,112
Other receivables	11,237	15,948
Financial assets classified as held for trading:		
Derivatives	170,956	151,578
Financial assets designated at fair value through profit or loss	2,589	1,907
	<u>364,516</u>	<u>325,850</u>
<b>Unrecognised financial instruments</b>		
Letters of credit	-	1
Lease commitments	28	31
Loan commitments	521	26
Unsettled reverse repurchase agreements	32,856	18,458
	<u>397,921</u>	<u>344,366</u>

*Maximum exposure to credit risk by credit rating\**

<b>Credit rating</b>	<b>Gross credit exposure 30 June 2010 \$millions</b>	<b>Gross credit exposure 31 December 2009 \$millions</b>
AAA	10,406	11,351
AA	113,928	107,219
A	221,604	170,854
BBB	19,832	14,126
BB	4,307	3,551
B	19,263	24,876
CCC	4,979	5,336
D	-	1
Unrated	3,602	7,052
Total	<u>397,921</u>	<u>344,366</u>

\* Internal credit rating derived using methodologies generally consistent with those used by external rating agencies

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity risk**

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

The Morgan Stanley Group's senior management establishes the overall liquidity and funding policies of the Morgan Stanley Group and the liquidity risk management policies and procedures conducted within the Group are consistent with those of the Morgan Stanley Group. The Morgan Stanley Group's liquidity and funding risk management policies are designed to mitigate the potential risk that entities within the Morgan Stanley Group, including those of the Group, may be unable to access adequate financing to service their financial liabilities when they become payable without material, adverse franchise or business impact. The key objective of the liquidity and funding risk management framework is to support the successful execution of both the Group's and the Morgan Stanley Group's business strategies while ensuring ongoing and sufficient liquidity through the business cycle and during periods of stressed market conditions.

*Liquidity management policies*

The principal elements of the Morgan Stanley Group's and the Group's liquidity management framework, are the Contingency Funding Plan ("CFP") and liquidity reserves. Comprehensive financing guidelines (secured funding, long-term funding strategy, surplus capacity, diversification and staggered maturities) support the Morgan Stanley Group, as well as the Group's, target liquidity profile.

*Contingency Funding Plan.* CFP is the Morgan Stanley Group's primary liquidity risk management tool. The CFP models a potential, prolonged liquidity contraction over a one-year time period and sets forth a course of action to effectively manage a liquidity event. The CFP and liquidity risk exposures are evaluated on an on-going basis and reported to the Firm Risk Committee, Asset / Liability Management Committee, and other appropriate risk committees including the European Financial Risk Committee.

CFP is produced on a Morgan Stanley Group as well as major group and subsidiary level, including the Group, to capture specific cash requirements and cash availability at various legal entities. The CFP assumes that Morgan Stanley does not have access to cash that may be held at certain subsidiaries due to regulatory, legal or tax constraints but that the Group does have access to the cash or liquidity reserve held by Morgan Stanley along with all other Morgan Stanley subsidiaries.

The Morgan Stanley Group's and the Group's CFP model incorporates scenarios with a wide range of potential cash outflows during a liquidity stress event, including, but not limited to, the following: (i) repayment of all unsecured debt maturing within one year and no incremental unsecured debt issuance; (ii) maturity roll-off of outstanding letters of credit with no further issuance and replacement of cash collateral; (iii) return of unsecured securities borrowed and any cash raised against these securities; (iv) additional collateral that would be required by counterparties in the event of a three-notch long-term credit ratings downgrade; (v) higher haircuts on or lower availability of secured funding; (vi) client cash withdrawals; (vii) drawdowns on unfunded commitments provided to third parties; and (viii) discretionary unsecured debt buybacks.

*Liquidity Reserves.* The Morgan Stanley Group and the Group seeks to maintain target liquidity reserves that are sized to cover daily funding needs and meet strategic liquidity targets as outlined in CFP. These liquidity reserves are held in the form of cash deposits and pools of central bank eligible unencumbered securities. The Group's liquidity reserve is managed locally and consists of overnight cash deposits and unencumbered U.S. and European government bonds, agencies and agency pass throughs. In addition to the liquidity reserve held by the Group, the Group has access to the liquidity reserve held by Morgan Stanley. The Morgan Stanley liquidity reserve is managed globally and consists of overnight cash deposits and unencumbered U.S. and European government bonds, agencies and agency pass throughs. The Morgan Stanley Group and the Group believes that diversifying the form in which its liquidity reserves are maintained (cash and securities) enhances its ability to quickly and efficiently source funding in a stressed environment. The Morgan Stanley Group's and the Group's funding requirements and target liquidity reserves may vary based on changes to the level and composition of its balance sheet, timing of specific transactions, client financing activity, market conditions and seasonal factors.

NOTES TO THE CONDENSED FINANCIAL STATEMENTS

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5. FINANCIAL RISK MANAGEMENT (CONTINUED)

**Liquidity risk (continued)**

*Funding management policies*

The Morgan Stanley Group's funding management policies are designed to provide for financings that are executed in a manner that reduces the risk of disruption to the Morgan Stanley Group's and the Group's operations. The Morgan Stanley Group pursues a strategy of diversification of secured and unsecured funding sources (by product, by investor and by region) and attempts to ensure that the tenor of the Morgan Stanley Group's, and the Group's, liabilities equals or exceeds the expected holding period of the assets being financed. Maturities of financings are designed to manage exposure to refinancing risk in any one period.

The Morgan Stanley Group funds its balance sheet on a global basis through diverse sources. These sources may include the Morgan Stanley Group's equity capital, long-term debt, repurchase agreements, securities lending, deposits, commercial paper, letters of credit and lines of credit. The Morgan Stanley Group has active financing programs for both standard and structured products in the U.S., European and Asian markets, targeting global investors and currencies such as U.S. dollar, Euro, British pound, Australian dollar and Japanese Yen.

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

*Maturity analysis*

In the following maturity analysis of financial liabilities, derivative contracts and other financial liabilities held as part of the Group's trading activities are disclosed on demand and presented at fair value, consistent with how these financial liabilities are managed. Financial liabilities designated at fair value are disclosed according to their earliest contractual maturity; all such amounts are presented at their fair value, consistent with how these financial liabilities are managed. All other amounts represent undiscounted cash flows payable by the Group arising from its financial liabilities to earliest contractual maturities as at 30 June 2010, and as at 31 December 2009. Repayments of financial liabilities that are subject to immediate notice are treated as if notice were given immediately and are classified as on demand. This presentation is considered by the Group to appropriately reflect the liquidity risk arising from those financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial liabilities is managed by the Group.

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity risk (continued)**

*Maturity analysis (continued)*

	On demand	Less than 1 month	More than 1 month but less than 3 months	More than 3 months but less than 1 year	More than 1 year but less than 5 years	More than 5 years	Total
30 June 2010	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
<b>Financial liabilities</b>							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	203	-	-	-	-	-	203
Securities loaned	35,468	3,706	3,150	4,705	500	-	47,529
Repurchase agreements	32,216	32,254	12,900	4,270	319	-	81,959
Trade payables	87,355	-	-	-	-	-	87,355
Other payables	24,701	-	-	-	-	-	24,701
Subordinated loans	-	13	26	118	630	10,275	11,062
Preference shares *	-	-	21	-	139	1,408	1,568
Financial liabilities classified as held for trading							
Derivatives	195,516	-	-	-	-	-	195,516
Other	29,329	-	-	-	-	-	29,329
Financial liabilities designated at fair value through profit or loss	6,328	74	67	766	1,534	637	9,406
<b>Total financial liabilities</b>	<b>411,116</b>	<b>36,047</b>	<b>16,164</b>	<b>9,859</b>	<b>3,122</b>	<b>12,320</b>	<b>488,628</b>
<b>Unrecognised financial instruments</b>							
Letters of credit	-	-	-	-	-	-	-
Lease commitments	8	-	-	-	-	20	28
Loan commitments	521	-	-	-	-	-	521
Unsettled reverse repurchase agreements	32,856						32,856
<b>Total unrecognised financial instruments</b>	<b>33,385</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>20</b>	<b>33,405</b>

\* Preference shares are assumed to be redeemed in 20 years.

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



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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity risk (continued)**

*Maturity analysis (continued)*

	On demand	Less than 1 month	More than 1 month but less than 3 months	More than 3 months but less than 1 year	More than 1 year but less than 5 years	More than 5 years	Total
31 December 2009	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
<b>Financial liabilities</b>							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	126	-	-	-	-	-	126
Securities loaned	37,800	1,335	1,968	2,703	500	-	44,306
Repurchase agreements	6,505	52,019	4,617	2,650	-	-	65,791
Trade payables	64,557	-	-	-	-	-	64,557
Other payables	33,748	-	-	-	-	-	33,748
Subordinated loans	-	11	22	100	533	10,008	10,674
Preference shares *	-	-	-	21	139	1,408	1,568
Financial liabilities classified as held for trading							
Derivatives	169,553	-	-	-	-	-	169,553
Other	34,002	-	-	-	-	-	34,002
Financial liabilities designated at fair value through profit or loss	4,750	104	86	521	1,293	1,125	7,879
<b>Total financial liabilities</b>	<b>351,041</b>	<b>53,469</b>	<b>6,693</b>	<b>5,995</b>	<b>2,465</b>	<b>12,541</b>	<b>432,204</b>
<b>Unrecognised financial instruments</b>							
Letters of credit	1	-	-	-	-	-	1
Lease commitments	8	-	-	-	-	23	31
Loan commitments	26	-	-	-	-	-	26
Unsettled reverse repurchase agreements	18,458	-	-	-	-	-	18,458
<b>Total unrecognised financial instruments</b>	<b>18,493</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>23</b>	<b>18,516</b>

\* Preference shares are assumed to be redeemed in 20 years.

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

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market risk**

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

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

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

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

*Primary market risk exposures and market risk management*

During the six months ended 30 June 2010, the Group had exposures to a wide range of interest rates, equity prices, foreign exchange rates and commodity prices and the associated implied volatilities and spreads, related to the global markets in which it conducts its trading activities. The Group is exposed to interest rate and credit spread risk as a result of its market-making activities and other trading in interest rate sensitive financial instruments (e.g. risk arising from changes in the level or implied volatility of interest rates, the shape of the yield curve and credit spreads). The activities from which those exposures arise and the markets in which the Group is active include, but are not limited to, the following: government debt, investment grade and non-investment grade corporate debt, interest rate derivatives, emerging market corporate and government debt, and distressed corporate debt.

The Group is exposed to equity price and implied volatility risk as a result of making markets in equity securities and derivatives as well as maintaining proprietary positions. The Group is exposed to foreign exchange rate and implied volatility risk as a result of making markets in foreign currencies and foreign currency derivatives and from holding non U.S. dollar-denominated financial instruments. The Group is exposed to commodity price and implied volatility risk as a result of market-making activities and maintaining positions in physical commodities (such as 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 physical production, transportation and storage issues; or geopolitical and other events that affect the available supply and level of demand for these commodities.

The Group, as part of the Morgan Stanley Group's global market risk management framework manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (e.g., futures, forwards, swaps and options). The Group manages the market risk associated with its trading activities on a Group basis, on a trading division level and on an individual product basis. The Group manages and monitors its market risk exposures in such a way as to maintain a portfolio that the Group believes is well-diversified in the aggregate with respect to market risk factors and that reflects the aggregate risk tolerance of key entities within the Group as established by the Group's key management personnel.

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market risk (continued)**

*Primary market risk exposures and market risk management (continued)*

Aggregate market risk limits have been approved for the key entities within the Group and major trading divisions globally (equity and fixed income, which includes interest rate products, credit products, foreign exchange and commodities) as well as for the Morgan Stanley Group. Additional market risk limits are assigned to trading desks and, as appropriate, products and regions. Trading division risk managers, desk risk managers, traders and the market risk department monitor market risk measures against limits in accordance with policies set by senior management.

The market risk department independently reviews the Group's trading portfolios on a regular basis from a market risk perspective utilising VaR and other quantitative and qualitative risk measures and analyses. The Group's trading businesses and the market risk department also use, as appropriate, measures such as sensitivity to changes in interest rates, prices, implied volatilities and time decay to monitor and report market risk exposures. Net exposure, defined as the potential loss to the Group over a period of time in the event of default of a referenced asset, assuming zero recovery, is one key measure the Group employs to standardise the aggregation of market risk exposures across cash and derivative products. Stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors for certain products, is performed periodically and is reviewed by trading division risk managers, desk risk managers and the market risk department. The market risk department also conducts scenario analysis, which estimates the revenue sensitivity of key entities within the Group to a set of specific, predefined market and geopolitical events.

*VaR*

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

*VaR methodology, assumptions and limitations*

The Group estimates VaR using a model based on historical simulation for major market risk factors and Monte Carlo simulation for name-specific risk in certain equity and fixed income exposures. Historical simulation involves constructing a distribution of hypothetical daily changes in the value of trading portfolios based on two sets of inputs: historical observation of daily changes in key market indices or other market factors ("market risk factors"); and information on the current sensitivity of the portfolio values to these market risk factor changes. The Group's VaR model uses approximately four years of historical data to characterise potential changes in market risk factors. The Group's 95%/one-day VaR corresponds to the unrealised loss in portfolio value that, based on historically observed market risk factor movements, would have been exceeded with a frequency of 5%, or five times in every 100 trading days, if the portfolio were held constant for one day.

The Group's VaR model generally takes into account linear and non-linear exposures to price risk and interest rate risk, and linear exposures to implied volatility risks. Market risks that are incorporated in the VaR model include equity and commodity prices, interest rates, foreign exchange rates and associated implied volatilities. As a supplement to the use of historical simulation for major market risk factors, the Group's VaR model uses Monte Carlo simulation to capture name-specific risk in equities and credit products (i.e. corporate bonds and credit derivatives).

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

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market Risk (continued)**

*VaR methodology, assumptions and limitations (continued)*

Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of varied market risks; reflect risk reduction due to portfolio diversification or hedging activities; and can cover a wide range of portfolio assets. However, VaR risk measures should be interpreted carefully in light of the methodology's limitations, which include the following: past changes in market risk factors may not always yield accurate predictions of the distributions and correlations of future market movements; changes in portfolio value in response to market movements (especially for complex derivative portfolios) may differ from the responses calculated by a VaR model; VaR using a one-day time horizon may not fully capture the market risk of positions that cannot be liquidated or hedged within one day; the historical market risk factor data used for VaR estimation may provide only limited insight into losses that could be incurred under market conditions that are unusual relative to the historical period used in estimating the VaR; and published VaR results reflect past trading positions while future risk depends on future positions. The Group is aware of these and other limitations and, therefore, uses VaR as only one component in its risk management oversight process. As explained above, this process also incorporates stress testing and scenario analyses and extensive risk monitoring, analysis, and control at the trading desk, division, entity and group levels.

*VaR for the six months ended 30 June 2010*

The table below presents the Group's aggregate VaR (trading VaR and non-trading VaR) for each of the Group's primary market risk exposures at 30 June 2010 and 31 December 2009 incorporating substantially all financial instruments generating market risk that are managed by the Group's trading businesses. This measure of VaR incorporates most of the Group's trading-related market risks. However, a small proportion of trading positions generating market risk is not included in VaR, and the modelling of the risk characteristics of some positions relies upon approximations that, under certain circumstances, could produce different VaR results from those produced using more precise measures. Also, the non-trading VaR excludes the Group's own credit risk generated through counterparty trades and through primary issuance.

The counterparty portfolio, which reflects adjustments, net of hedges, relating to counterparty credit risk and other market risks, was reclassified from Non-Trading VaR into Trading VaR as of 1 January 2010. This reclassification reflects regulatory considerations surrounding the Morgan Stanley Group's conversion to a financial holding company, and the trading book nature of the Company's counterparty risk-hedging activities. Total Trading and Non-Trading VaR was not affected by this change; however this reclassification increased Trading VaR and decreased Non-Trading VaR.

Since the VaR statistics reported below are estimates based on historical position and market 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. VaR does not predict the magnitude of losses which, should they occur, may be significantly greater than the VaR amount.

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market Risk (continued)**

*VaR for the six months ended 30 June 2010 (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% total VaR primary market risk category	As at 30 June 2010			As at 31 December 2009		
	Aggregate \$millions	Trading \$millions	Non-Trading \$millions	Aggregate \$millions	Trading \$millions	Non-Trading \$millions
Interest rate and credit spread	74	72	6	47	38	18
Equity price	18	18	2	12	12	1
Foreign exchange rate	9	9	-	8	7	2
Commodity price	5	5	-	3	3	-
Subtotal	106	104	8	70	60	21
Less diversification benefit (1)	41	39	1	17	16	3
<b>Total VaR</b>	<b>65</b>	<b>65</b>	<b>7</b>	<b>53</b>	<b>44</b>	<b>18</b>

(1) Diversification benefit equals the difference between Total 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.

The Group's trading VaR at 30 June 2010 was \$65 million compared with \$44 million at 31 December 2009. Excluding the counterparty portfolio, which has been reclassified from Non-Trading book to Trading book at the beginning of 2010, the Group's trading VaR at 30 June 2010 would have been \$55 million. The increase excluding the counterparty portfolio has been driven primarily by an increase in interest rate and credit spread risk combined with increased equity price risk.

The Group views average trading VaR over the fiscal year as more representative of trends in the business than VaR at any single point in time. The table below, which presents the high, low and average 95%/one-day trading VaR during the six months to 30 June 2010, represents substantially all of the Group's trading activities. Certain market risks included in the aggregate VaR discussed above are excluded from these measures.

95% One-day high/low/average Trading VaR primary market risk category	Six months ended 30 June 2010			Year ended 31 December 2009		
	High \$millions	Low \$millions	Average \$millions	High \$millions	Low \$millions	Average \$millions
Interest rate and credit spread	75	35	56	61	27	37
Equity price	28	13	18	22	10	14
Foreign exchange rate	18	4	10	19	3	9
Commodity price	9	2	4	4	1	2
<b>Trading VaR</b>	<b>79</b>	<b>41</b>	<b>60</b>	<b>72</b>	<b>26</b>	<b>40</b>

Average Trading VaR for the six months ended 30 June 2010 was \$60 million, \$20 million higher than the average trading VaR for the year ended 31 December 2009. Excluding the counterparty portfolio, which has been reclassified from Non-Trading book to Trading book at the beginning of 2010, the average Trading VaR for the six months ended 30 June 2010 would have been \$54 million. The increase excluding the counterparty portfolio has been driven primarily by an increase in interest rate and credit spread risk and equity price risk.

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**5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market risk (continued)**

*Interest rate risk*

The Group's VaR excludes certain funding liabilities and money market transactions. As at 30 June 2010, the net notional amount of such funding liabilities and money market activities was approximately \$6.2 billion, compared to an asset of \$1.2 billion as at 31 December 2009. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net gain or loss of approximately \$5.6 million, compared to \$5.5 million as at 31 December 2009.

*Currency risk*

The Group has foreign currency exposure arising from its investments in branches and subsidiaries where those investments operate in currencies other than US dollars. The majority of this foreign currency risk has been hedged by other members of the Morgan Stanley Group, primarily Morgan Stanley, by utilising both forward foreign currency exchange contracts and non-US dollar denominated debt.

The analysis below details this foreign currency exposure for the Group, by foreign currency, and calculates the impact on total comprehensive income of a reasonably possible parallel shift of the foreign currency against the US dollar, with all other variables held constant. This analysis does not take into account the effect of any foreign currency hedges held by other members of the Morgan Stanley Group.

Foreign currency exposure	As at	Parallel shift %	Sensitivity \$millions	As at	Parallel shift %	Sensitivity \$millions
	30 June 2010 \$millions			31 December 2009 \$millions		
Australian Dollar	(5)	27%	1	(5)	27%	1
Euro	376	14%	53	394	14%	55
British Pound	42	29%	12	120	29%	35
New Taiwan Dollar	52	3%	2	92	3%	3
New Zealand Dollar	2	24%	-	2	24%	-
Singapore Dollar	4	3%	-	3	3%	-
South Korean Won	160	42%	67	138	42%	58
Swedish Krona	13	23%	3	14	23%	3
	<u>644</u>			<u>758</u>		

The parallel shift has been calculated based on the annualised percentage change in the respective foreign currency rates against US dollars from 1 December 2007 to 30 June 2010.

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE**

**a. Fair value hierarchy**

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

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

***Fair Value Control Processes***

The Group employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilised is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by Morgan Stanley Group personnel with relevant expertise who are independent from the trading desks.

Additionally, groups independent from the trading divisions within the financial control, market risk and credit risk management departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model.

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

*Financial assets and liabilities recognised at fair value*

The following table presents the carrying value of the Group's financial assets and liabilities, recognised at fair value, classified according to the fair value hierarchy described above:

	At 30 June 2010			
	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant non- observable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
- Government debt securities	11,858	3,331	-	15,189
- Corporate equities	35,300	638	47	35,985
- Corporate and other debt	-	16,494	3,411	19,905
- Derivatives	2,058	184,398	3,107	189,563
Total financial assets classified as held for trading	49,216	204,861	6,565	260,642
Financial assets designated at fair value through profit or loss	-	860	1,729	2,589
Available-for-sale financial assets				
- Corporate equities	-	-	44	44
Total financial assets held at fair value	49,216	205,722	8,338	263,275
Financial liabilities classified as held for trading:				
- Government debt securities	11,545	2,846	-	14,391
- Corporate equities	13,900	185	5	14,090
- Corporate and other debt	-	764	84	848
- Derivatives	2,447	187,679	5,390	195,516
Total financial liabilities classified as held for trading	27,892	191,474	5,479	224,845
Financial liabilities designated at fair value through profit or loss – structured notes and prepaid derivatives	-	7,606	1,800	9,406
Total financial liabilities at fair value	27,892	199,080	7,279	234,251



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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

*Financial assets and liabilities recognised at fair value (continued)*

	At 31 December 2009			
	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant non- observable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
- Government debt securities	11,921	948	2	12,871
- Corporate equities	42,413	2,241	49	44,703
- Corporate and other debt	10	18,143	2,351	20,504
- Derivatives	1,175	160,586	4,234	165,995
Total financial assets classified as held for trading	55,519	181,918	6,636	244,073
Financial assets designated at fair value through profit or loss <sup>(1)</sup>	-	496	1,411	1,907
Available-for-sale financial assets				
- Corporate equities	1	-	42	43
Total financial assets held at fair value	55,520	182,414	8,089	246,023
Financial liabilities classified as held for trading:				
- Government debt securities	10,585	1,274	-	11,859
- Corporate equities	14,143	1,521	3	15,667
- Corporate and other debt	69	6,403	4	6,476
- Derivatives	1,352	162,305	5,896	169,553
Total financial liabilities classified as held for trading	26,149	171,503	5,903	203,555
Financial liabilities designated at fair value through profit or loss – structured notes and prepaid derivatives <sup>(1)</sup>	-	6,987	892	7,879
Total financial liabilities at fair value	26,149	178,490	6,795	211,434

(1) Certain financial assets designated at fair value through profit or loss and financial liabilities designated at fair value through profit or loss have been represented as Level 2.

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

*Financial assets and liabilities recognised at fair value (continued)*

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

*Government debt securities*

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

*Corporate equities*

- Exchange Traded Equity Securities. Exchange traded equity securities are generally valued based on quoted prices from the exchange. To the extent these securities are actively traded, valuation adjustments are not applied and they are categorised in Level 1 of the fair value hierarchy; otherwise, they are categorised in Level 2.
- Investments (other than investments in other Morgan Stanley Group undertakings). The Group's investments include direct private equity investments and investments in private equity funds, real estate funds and hedge funds. Initially, the transaction price is generally considered by the Group as the exit price and is the Group's best estimate of fair value.

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

*Corporate and other debt*

- Residential Mortgage-Backed Securities ("RMBS"), Commercial Mortgage-Backed Securities ("CMBS"), and other Asset-Backed Securities ("ABS"). RMBS, CMBS and other ABS may be valued based on external price or spread data. When position-specific external price data are not observable, the valuation is based on prices of comparable bonds. Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

Fair value for retained interests in securitised financial assets (in the form of one or more tranches of the securitisation) is determined using observable prices or, in cases where observable prices are not available for certain retained interests, the fair value is estimated based on the present value of expected future cash flows using the best estimate of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved.

RMBS, CMBS and other ABS, including retained interests in these securitised financial assets, are categorised in Level 3 if external prices or spread inputs are unobservable or if the comparability assessment involves significant subjectivity related to property type differences, cash flows, performance and other inputs; otherwise, they are categorised in Level 2 of the fair value hierarchy.

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

*Financial assets and liabilities recognised at fair value (continued)*

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

*Corporate and other debt (continued)*

- **Corporate Bonds.** The fair value of corporate bonds is estimated using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data does not reference the issuer, then data that reference a comparable issuer is used. When observable price quotations are not available, fair value is determined based on cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates based on collateral values as significant inputs. Corporate bonds are generally categorised in Level 2 of the fair value hierarchy; in instances where prices, spreads or any other of the aforementioned key inputs are unobservable, they are categorised in Level 3 of the fair value hierarchy.
- **Collateralised Debt Obligations (“CDOs”).** The Group holds CDOs where the collateral primarily is synthetic and references either a basket credit default swap or CDO-squared (a CDO-squared is a special purpose vehicle that issues interests, or tranches, that are backed by tranches issued by other CDOs). The correlation input between reference credits within the collateral is unobservable and is benchmarked to standardised proxy baskets for which correlation data are available. The other model inputs such as credit spreads, interest rates and recovery rates are observable. CDOs are categorised in Level 2 of the fair value hierarchy when the correlation input is insignificant. In instances where the correlation input is deemed to be significant, these instruments are categorised in Level 3 of the fair value hierarchy.

*Derivatives*

- **Listed derivatives 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 analytical 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 are widely accepted by the financial services industry. A substantial majority of OTC derivative products valued using pricing models fall into this category and are categorised within Level 2 of the fair value hierarchy.

Other derivative products, including complex products that have become illiquid, require more judgment in the implementation of the valuation technique applied due to the complexity of the valuation assumptions and the reduced observability of inputs. This includes derivative interests in certain mortgage-related CDO securities, basket credit default swaps, CDO-squared positions and certain types of ABS credit default swaps 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.

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

*Financial assets and liabilities recognised at fair value (continued)*

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

*Derivatives (continued)*

Derivative interests in mortgage-related CDOs, and credit default swaps, for which observability of external price data is extremely 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 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 judgment.

For basket credit default swaps and CDO-squared positions, the correlation input between reference credits is unobservable for each specific swap 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. In instances where the correlation input is deemed to be significant, these instruments are categorised in Level 3 of the fair value hierarchy.

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

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

- Prepaid OTC Contracts and issued structured notes designated as fair value through profit or loss.

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

This includes financial liabilities such as those arising from the consolidation of certain special purpose entities and those that arise as a result of continuing recognition of certain assets, where the Group retains substantially all the risks and rewards of the transferred assets, and the simultaneous recognition of an associated liability. The fair value of these financial liabilities, which are effectively secured financing liabilities, is estimated using the appropriate valuation methodology for the related assets that continue to be recognised, adjusted for any differences between the assets that continue to be recognised and the liability that is simultaneously recognised. Generally these financial liabilities are recognised in Level 2 of the fair value hierarchy.

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**b. Changes in Level 3 assets and liabilities measured at fair value**

The following table presents the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the six months ended 30 June 2010.

2010 In \$millions	Balance at 1 January 2010	Total gains or (losses) recognised in profit or loss	Total gains or (losses) recognised in other comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 (1)	Balance at 30 June 2010	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 30 June 2010 (2)
Financial assets classified as held for trading:										
- Government debt securities	2	-	-	-	-	-	-	(2)	-	-
- Corporate equities	49	12	-	39	(70)	-	-	17	47	5
- Corporate and other debt	2,351	(40)	-	2,779	(976)	-	(712)	9	3,411	(119)
Financial assets designated at fair value through profit or loss:	1,411	171	-	147	-	-	-	-	1,729	171
Available-for-sale financial assets:										
- Corporate equities	42	-	1	2	(2)	-	1	-	44	-
Financial liabilities classified as held for trading:										
- Government debt securities	-	-	-	-	-	-	-	-	-	-
- Corporate equities	(3)	1	-	-	(4)	-	34	(33)	(5)	1
- Corporate and other debt	(4)	(9)	-	-	(21)	-	(88)	38	(84)	7
- Net derivative contracts (3)	(1,662)	(291)	-	-	-	-	(382)	52	(2,283)	(495)
Financial liabilities designated at fair value through profit or loss:	(892)	(92)	-	-	-	(1,108)	243	49	(1,800)	(92)
	1,294	(248)	1	2,967	(1,073)	(1,108)	(904)	130	1,059	(522)

(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 period.

(2) Amounts represent unrealised gains or (losses) for the six months ended 30 June 2010 related to assets and liabilities still outstanding at 30 June 2010.

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

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

2009 In \$millions	Balance at 1 January 2009	Total gains or losses recognised in profit or loss	Total gains or losses recognised in other comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 (1)	Balance at 31 December 2009	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 31 December 2009 (2)
Financial assets classified as held for trading:										
- Government debt securities	2	-	-	-	-	-	-	-	2	-
- Corporate equities	460	(63)	-	63	(131)	-	-	(280)	49	(34)
- Corporate and other debt	2,302	236	-	938	(704)	-	-	(421)	2,351	233
Financial assets designated at fair value through profit or loss:	1,131	643	-	3	-	-	(283)	(83)	1,411	643
Available-for-sale financial assets:										
- Corporate equities	87	-	(7)	-	(38)	-	-	-	42	-
Financial liabilities classified as held for trading:										
- Government debt securities	-	-	-	-	-	-	-	-	-	-
- Corporate equities	(24)	-	-	-	(10)	-	21	10	(3)	-
- Corporate and other debt	(88)	6	-	-	(18)	-	77	19	(4)	(24)
- Net derivative contracts (3)	(3,327)	1,548	-	-	-	-	(30)	147	(1,662)	1,042
Financial liabilities designated at fair value through profit or loss:	(515)	30	-	-	-	(380)	215	(242)	(892)	30
	28	2,400	(7)	1,004	(901)	(380)	-	(850)	1,294	1,890

(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 2009 related to assets and liabilities still outstanding at 31 December 2009.

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

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

As disclosed in note 8 the Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. Where the trading positions included in the above gains or losses are risk managed using financial instruments across a number of Morgan Stanley Group entities, these policies potentially result in the recognition of offsetting gains or losses in the Group.

During the six months ended 30 June 2010, there were no significant transfers between Level 2 and Level 3 of the fair value hierarchy.

For the year ended 31 December 2009 the Group reclassified approximately \$95 million of derivative contracts and structured notes from Level 2 to Level 3. The reclassifications primarily related to exotic equity linked notes and were due to certain significant inputs for the fair value measurement becoming unobservable.

The Group reclassified approximately \$755 million of derivative contracts and corporate and other debt from Level 3 to Level 2 for the year ended 31 December 2009. The reclassifications primarily related to debt linked bonds and interests in hedge funds and were due to an increase in market price quotations for these or comparable instruments, such that observable inputs were utilised for the fair value measurement.

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

During the six months ended 30 June 2010, and the year ended 31 December 2009, there were no significant reclassifications between Level 1 and Level 2.

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

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

In estimating the change in fair value, the unobservable parameters were varied to the extremes of the ranges of reasonably possible alternatives using statistical techniques, such as dispersion in comparable observable external inputs for similar asset classes, historic data or judgment if a statistical technique is not appropriate. Where a financial instrument has more than one unobservable parameter, the sensitivity analysis reflects the greatest increase or decrease to fair value by varying the assumptions individually. It is unlikely that all unobservable parameters would concurrently be 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.

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**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

The following table presents the sensitivity of the fair value of Level 3 financial assets and financial liabilities as at 30 June 2010 to reasonably possible alternative assumptions.

30 June 2010	Effect of reasonably possible alternative assumptions		
	Fair Value \$millions	Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	47	5	(5)
- Corporate and other debt	3,411	252	(257)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	1,729	9	(1)
Available-for-sale financial assets:			
- Corporate equities	44	-	-
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	(5)	-	-
- Corporate and other debt	(84)	1	(2)
- Net derivatives contracts <sup>(1)</sup>	(2,283)	164	(175)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	(230)	9	(9)
- Note issuances	(11)	-	-
- Other	(1,559)	119	(119)

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



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**Six months ended 30 June 2010**

**6. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

The following table presents the sensitivity of the fair value of Level 3 financial assets and financial liabilities as at 31 December 2009 to reasonably possible alternative assumptions.

31 December 2009	Effect of reasonably possible alternative assumptions		
	Fair Value \$millions	Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
- Government debt securities	2	-	-
- Corporate equities	49	1	(4)
- Corporate and other debt	2,351	141	(123)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	1,411	8	(8)
Available-for-sale financial assets:			
- Corporate equities	42	-	-
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	(3)	-	-
- Corporate and other debt	(4)	3	(6)
- Net derivatives contracts <sup>(1)</sup>	(1,662)	149	(154)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	(188)	1	(1)
- Note issuances	(61)	1	(1)
- Other	(643)	30	(30)

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

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**6. 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:

	<b>30 June 2010</b>	<b>30 Dec 2009</b>
	<b>\$millions</b>	<b>\$millions</b>
At the beginning of the period	215	281
New transactions	58	42
Amounts recognised in the consolidated income statement during the period	-	(108)
At the end of the year period	<u>273</u>	<u>215</u>

The balance above predominantly relates to derivatives.

The statement of financial position categories 'Financial assets and financial liabilities classified as held for trading', 'Financial assets and financial liabilities designated at fair value', and 'Available-for-sale financial assets' include financial instruments whose fair value is based on valuation techniques using unobservable market data.

**7. LITIGATION**

On 25 September 2009, the Group was named as a defendant in a lawsuit styled *Citibank, N.A. v. Morgan Stanley & Co. International, PLC*, which is pending in the United States District Court for the Southern District of New York. The lawsuit relates to a credit default swap entered into by the Group referencing the Capmark VI CDO, ("Capmark") which was structured by Citibank, N.A. ("Citi N.A."). At issue is whether, as part of the swap agreement, Citi N.A. was obligated to obtain the Group's prior written consent before it exercised its rights to liquidate Capmark upon the occurrence of certain contractually-defined credit events. Citi N.A. is seeking approximately \$245 million in compensatory damages plus interest and costs. On 13 May 2010, the court granted Citi N.A.'s motion for judgement on the pleadings on its claim for breach of contract. The Group plans to appeal that decision and has asserted equitable counterclaims which are still pending. A litigation provision has not been made in relation to Capmark. In compliance with the intra-group policies discussed in note 8, revenues and costs related to the Capmark deal referenced above, including any potential litigation costs, are transferred to other Morgan Stanley Group undertakings outside the Group.

**8. RELATED PARTY DISCLOSURES**

The management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. For the six months ended 30 June 2010, a net loss of \$686 million was recognised in the consolidated income statement arising from such policies (30 June 2009: net loss of \$496 million).