

Morgan Stanley & Co. Incorporated

Consolidated Statement of Financial Condition

May 31, 2006
(Unaudited)

Investments and services are offered through Morgan Stanley & Co. Incorporated.

Morgan Stanley

Morgan Stanley & Co. Incorporated

Consolidated Statement of Financial Condition (Unaudited)

(In thousands of dollars, except share data)

May 31, 2006

Assets

Cash	\$ 684,903
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements (including securities at fair value of \$23,099,943)	33,624,157
Financial instruments owned (approximately \$34,050,140 was pledged to various parties):	
U.S. government and federal agency securities	19,160,318
Corporate and other debt	33,484,311
Corporate equities	15,076,992
Derivative contracts	5,505,262
Securities received as collateral	57,223,274
Collateralized agreements:	
Securities purchased under agreement to resell	92,659,685
Securities borrowed	222,932,196
Receivables:	
Customers	56,322,617
Brokers, dealers and clearing organizations	7,759,715
Interest and dividends	958,808
Fees and other	2,586,779
Affiliates	141,309
Office facilities at cost (less accumulated depreciation and amortization of \$318,792)	264,463
Other assets	1,231,329
Total assets	<u>\$549,616,118</u>

Liabilities and Stockholder's Equity

Short-term borrowings:	
Affiliates	\$ 38,514,410
Other	393,053
Financial instruments sold, not yet purchased:	
U.S. government and federal agency securities	16,231,170
Corporate and other debt	3,211,192
Corporate equities	7,913,271
Derivative contracts	8,133,429
Obligation to return securities received as collateral	57,223,274
Collateralized Financings:	
Securities sold under agreements to repurchase	170,341,447
Securities loaned	145,861,513
Other secured financings	1,567,371
Payables:	
Customers	65,905,515
Brokers, dealers and clearing organizations	16,857,653
Interest and dividends	1,878,934
Other liabilities and accrued expenses	3,955,342
	<u>537,987,574</u>
Subordinated liabilities	6,225,000
Stockholder's equity:	
Common stock (\$25 par value, 1,000 shares authorized, issued and outstanding)	25
Paid-in capital	738,237
Retained earnings	4,665,282
Total stockholder's equity	<u>5,403,544</u>
Total liabilities and stockholder's equity	<u>\$549,616,118</u>

See Notes to Consolidated Statement of Financial Condition.

Morgan Stanley & Co. Incorporated

Notes to Consolidated Statement of Financial Condition

(Unaudited)

(In thousands of dollars, except where noted)

May 31, 2006

NOTE 1 -**Introduction and Basis of Presentation****The Company**

Morgan Stanley & Co. Incorporated ("MS&Co."), together with its wholly owned subsidiaries, (the "Company") provides a wide range of financial and securities services. Its businesses include securities underwriting and distribution; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; sales, trading, financing and market-making activities in equity securities and related products and fixed income securities and related products including foreign exchange. The Company provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals.

MS&Co. and certain of its subsidiaries are registered with the Securities and Exchange Commission ("SEC") as broker-dealers. MS&Co. is also registered as a futures commission merchant with the Commodity Futures Trading Commission ("CFTC"). The Company is a wholly owned subsidiary of Morgan Stanley (the "Parent").

Basis of Financial Information

The consolidated statement of financial condition is prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, the outcome of litigation and other matters that affect the consolidated statement of financial condition and related disclosures. The Company believes that the estimates utilized in the preparation of the consolidated statement of financial condition are prudent and reasonable. Actual results could differ materially from these estimates.

At May 31, 2006, the Company's consolidated subsidiaries reported \$253,915,372 of assets, \$252,962,714 of liabilities and \$952,658 of equity on a standalone basis.

The consolidated statement of financial condition includes the accounts of MS&Co. and its wholly owned subsidiaries. The Company's policy is to consolidate all entities in which it owns more than 50% of the outstanding voting stock unless it does not control the entity. The Company also consolidates any variable interest entities for which it is the primary beneficiary (see NOTE 8).

The majority of the Company's assets and liabilities are recorded at fair value or at amounts that approximate fair value. Such assets and liabilities include: cash and cash equivalents, cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements, customer and brokers, dealers and clearing organizations receivables and payables, financial instruments owned, securities purchased under agreement to resell, securities sold under agreement to repurchase, securities borrowed, securities loaned, certain other assets, other short-term borrowings and financial instruments sold, not yet purchased.

All material intercompany balances and transactions have been eliminated in consolidation.

Related Party Transactions

The Company has transactions with the Parent and its affiliates, including the performance of administrative services and the execution of securities transactions with and on behalf of affiliates and obtains short-term funding as described in NOTE 4.

Receivables from affiliated companies as of May 31, 2006 are comprised of:

Securities purchased under agreements to resell ("reverse repurchase agreements")	\$ 23,319,883
Securities borrowed	26,396,321
Customers	9,825,453
Brokers, dealers and clearing organizations	3,498,704
Interest and dividends	82,782
Fees and other	647,324
	<u>\$ 63,770,467</u>

Payables to affiliated companies as of November 30, 2005 are comprised of:

Securities sold under agreements to repurchase ("repurchase agreements")	\$ 48,261,592
Securities loaned	60,417,338
Customers	2,914,066
Brokers, dealers and clearing organizations	12,032,057
Interest and dividends	843,950
Other liabilities and accrued expenses	655,811
	<u>\$125,124,814</u>

Morgan Stanley & Co. Incorporated

NOTE 2 -**Summary of Significant Accounting Policies****Cash and Cash Equivalents**

Cash and cash equivalents consist of cash and highly liquid investments not held for resale with maturities, when purchased, of three months or less.

Cash and Securities Deposited With Clearing Organizations or Segregated Under Federal and Other Regulations or Requirements

Cash and securities deposited with clearing organizations or segregated under federal and other regulations include cash and securities segregated in compliance with federal and other regulations and represent funds deposited by customers and funds accruing to customers as a result of trades or contracts.

Financial Instruments Used for Trading and Investment

Financial instruments owned and financial instruments sold, not yet purchased, which include cash and derivative products, are recorded at fair value in the consolidated statement of financial condition. Fair value is the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The fair value of the Company's financial instruments owned and financial instruments sold, not yet purchased are generally based on observable market prices, observable market parameters or derived from such prices or parameters based on bid prices or parameters for financial instruments owned and ask prices or parameters for financial instruments sold, not yet purchased. In the case of financial instruments transacted on recognized exchanges, the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded. Bid prices represent the highest price a buyer is willing to pay for a financial instrument at a particular time. Ask prices represent the lowest price a seller is willing to accept for a financial instrument at a particular time.

A substantial percentage of the fair value of the Company's financial instruments owned and financial instruments sold, not yet purchased, is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary from product to product. Where available, observable market prices and pricing parameters in a product (or a related product) may be used to derive a price without requiring significant judgment. In certain markets,

observable market prices or market parameters are not available for all products and fair value is determined using techniques appropriate for each particular product. These techniques involve some degree of judgment. The price transparency of the particular product will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of product, whether it is a new product and not yet established in the marketplace, and the characteristics particular to the transaction. Products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, products that are thinly or not quoted will generally have reduced to no price transparency.

The fair value of over-the-counter ("OTC") derivative contracts is derived primarily using pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value is based on the transaction price. The Company also uses pricing models to manage the risks introduced by OTC derivatives. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modeled using a series of techniques, including closed form analytic formulae, such as the Black-Scholes option pricing model, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

Purchases and sales of financial instruments as well as commission revenues and related expenses are recorded in the accounts on trade date. Unrealized gains and losses arising from the Company's dealings in OTC financial instruments are presented in the accompanying consolidated statement of financial condition on a net-by-counterparty basis, when appropriate.

Morgan Stanley & Co. Incorporated

Securities purchased in connection with principal investment activities initially are carried in the consolidated statement of financial condition at their original costs, which approximate fair value. The carrying value of such securities is adjusted when changes in the underlying fair values are readily ascertainable, generally as evidenced by observable market prices or transactions that directly affect the value of such securities. Downward adjustments relating to such securities are made in the event that the Company determines that the fair value is less than the carrying value. The Company's principal investments, are included within other assets in the consolidated statement of financial condition.

Receivables and Payables – Customers

Receivables from and payables to customers include amounts due on cash and margin transactions. Securities owned by customers, including those that collateralize margin or similar transactions, are not reflected on the consolidated statement of financial condition.

Receivables and Payables – Brokers, Dealers and Clearing Organizations

Receivables from brokers, dealers and clearing organizations include amounts receivable for securities not delivered by the Company to a purchaser by the settlement date, margin deposits, commissions, and net receivables arising from unsettled trades. Payable to brokers, dealers and clearing organizations include amounts payable for securities not received by the Company from a seller by the settlement date.

Office Facilities

Office facilities are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of office facilities are provided principally by the straight-line method over the estimated useful life of the asset. Estimates of useful lives are 7 years for furniture and fixtures and 3 to 5 years for computer and communication equipment. Leasehold improvements are amortized over the lesser of the estimated useful life of the asset or, where applicable, the remaining term of the lease, but generally not exceeding 15 years.

Software Costs

In accordance with American Institute of Certified Public Accountants Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," certain costs incurred in connection with internal-use software projects are capitalized and amortized over the expected useful life of the asset of 3 years.

Customer Transactions

Customers' securities transactions are recorded on a settlement date basis with related commission revenues and expenses recorded on trade date basis.

Investment Banking

Underwriting revenues and fees for mergers, acquisitions and advisory assignments are recorded when services for the transactions are determined to be completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of legal, travel and other costs directly associated with the transaction, are deferred and recognized in the same period as the related investment banking transaction revenue.

Income Taxes

Income taxes are provided using the asset and liability method, under which deferred tax assets and liabilities are determined based upon the temporary differences between the financial statement and income tax bases of assets and liabilities using currently enacted tax rates.

Foreign Currency Transactions

Non-U.S. dollar denominated assets and liabilities are translated at fiscal year-end rates of exchange.

Securitization Activities

The Company engages in securitization activities related to U.S. agency collateralized mortgage obligations, corporate and municipal bonds and other types of financial assets. The Company may retain interests in the securitized financial assets as one or more tranches of the securitization, and rights to any excess cash flows remaining after payments to investors in the securitization trusts of their contractual rate of return and reimbursement of credit losses. The exposure to credit losses from securitized financial assets is limited to the Company's retained contingent risk, which represents the Company's retained interest in securitized financial assets. The gain or loss on the sale of financial assets depends in part on the previous carrying amount of the assets involved in the transfer and each subsequent transfer in revolving structures, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. To obtain fair values, observable market prices are used if available. However, observable market prices are generally not available for retained interests, so the Company estimates fair value based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, payment rates, forward yield curves and discount rates commensurate with the risks involved.

Morgan Stanley & Co. Incorporated

NOTE 3 -**Collateralized Financing and Securitization Transactions**

Reverse repurchase agreements and repurchase agreements, principally U.S. government and federal agency securities, are carried at the amounts at which the securities subsequently will be resold or reacquired as specified in the respective agreements; such amounts include accrued interest. Reverse repurchase agreements and repurchase agreements are presented on a net-by-counterparty basis, when appropriate. The Company's policy is to take possession of securities purchased under agreements to resell. Securities borrowed and securities loaned are also carried at the amounts of cash collateral advanced and received in connection with the transactions. Other secured financings include the liabilities related to transfers of financial assets that are accounted for as financings rather than sales and consolidated variable interest entities where the Company is the primary beneficiary where in all instances these liabilities are payable solely from the cash flows of the related assets accounted for as financial instruments owned.

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financing. Pledged securities that can be sold or repledged by the secured party are identified as financial instruments owned (pledged to various parties) on the consolidated statement of financial condition. The carrying value and classification of securities financial instruments owned by the Company that have been loaned or pledged to counterparties where those parties do not have the right to sell or repledge the collateral were approximately:

	May 31, 2006
Financial instruments owned:	
U.S. government and federal agency	\$12,988,000
Corporate and other debt	3,927,000
Corporate equities	5,420,000
Total	<u>\$22,335,000</u>

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, finance the Company's inventory positions, acquire securities to cover short positions and settle other securities obligations and to accommodate customers' needs. The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, corporate and other debt, and corporate equities. The Company receives collateral in the

form of securities in connection with reverse repurchase agreements, securities borrowed transactions and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending transactions or for delivery to counterparties to cover short positions. At May 31, 2006, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$569,506,000, and the fair value of the portion that has been sold or repledged was \$536,682,000.

On the consolidated statement of financial condition, the Company recognized the fair value of an asset for securities received as collateral (as opposed to cash received as collateral) and a corresponding liability, obligation to return securities received as collateral in certain securities lending transactions.

The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. For these transactions, adherence to the Company's collateral policies significantly limits the Company's credit exposure in the event of customer default. The Company may request additional margin collateral from customers, if appropriate, and if necessary may sell securities that have not been paid for or purchase securities sold, but not yet delivered by customers.

The Company engages in securitization activities related to U.S. agency collateralized mortgage obligations, corporate and municipal bonds and other types of financial assets. These assets are carried at fair value. The Company may act as underwriter of the beneficial interests issued by securitization vehicles. Underwriting net revenues are recognized in connection with these transactions. The Company may retain interests in the securitized financial assets as one or more

Morgan Stanley & Co. Incorporated

tranches of the securitization. These retained interests are included in the consolidated statement of financial condition at fair value. Retained interests in securitized financial assets were approximately \$1,927,350 at May 31, 2006 which were related to U.S. agency collateralized mortgage obligation securitization transactions. Assumptions that the Company used to determine the fair value of its retained interests at the time of securitization related to those transactions that occurred during the year ended May 31, 2006 were not materially different from the assumptions included in the table below.

The following table presents information on the Company's U.S. agency collateralized mortgage obligation securitization transactions. Key economic assumptions and the sensitivity of the current fair value of the retained interests to immediate 10% and 20% adverse changes in those assumptions at May 31, 2006 were as follows:

	U.S. agency collateralized mortgage obligations
Retained interests (carrying amount/fair value)	\$864,744
Weighted average life (in months)	85
Credit losses (rate per annum)	-
Impact on fair value of 10% adverse change	-
Impact on fair value of 20% adverse change	-
Weighted average discount rate (rate per annum)	6.11%
Impact on fair value of 10% adverse change	\$(29,105)
Impact on fair value of 20% adverse change	\$(56,311)
Prepayment speed assumption	131—242 PSA
Impact on fair value of 10% adverse change	\$(4,006)
Impact on fair value of 20% adverse change	\$(7,443)

The table above does not include the offsetting benefit of any financial instruments that the Company may utilize to hedge risks inherent in its retained interests. In addition, the sensitivity analysis is hypothetical and should be used with caution. Changes in fair value based on a 10% or 20% variation in an assumption generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the retained interests is calculated independent of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. In addition, the sensitivity analysis does not consider any corrective action that the Company may take to mitigate the impact of any adverse changes in the key assumptions.

For the year ended May 31, 2006, the Company received \$4,463,225 of proceeds from new securitization transactions

and \$2,328,244 of cash flows from retained interests in securitization transactions.

NOTE 4 - Short-Term Borrowings

Short-term borrowings from affiliates are unsecured, bear interest at prevailing market rates and are payable on demand. Such balance consists primarily of intercompany funding from the Parent as well as other intercompany payables which settle in the normal course of business. Other short-term borrowings consist of loans which are unsecured, generally bear interest at rates based upon the federal funds rate and are payable on demand.

NOTE 5 - Subordinated Liabilities

Subordinated liabilities consist of a Cash Subordination Agreement and a Subordinated Revolving Credit Agreement with the Parent and a Subordinated Indenture ("Indenture") with J.P. Morgan Trust Company, N.A., as trustee, dated September 12, 1994, and modified as of November 28, 1995 and April 24, 1997.

The Cash Subordination Agreement is for \$2,500,000, bears interest at 6.55% per annum and has a maturity date of April 30, 2007. Additionally, \$2,200,000 is payable under the Company's \$5,000,000 Subordinated Revolving Credit Agreement which has a commitment termination date and maturity date of April 30, 2016 and April 30, 2017, respectively. Interest on this borrowing is payable at rates based upon the federal funds rate or the London Interbank Offered Rate.

The Indenture is comprised of the following:

<u>Subordinated Notes</u>	<u>Maturity Date</u>	<u>Interest Rate</u>	<u>Amount</u>
Series F	June 1, 2016	7.82%	<u>\$25,000</u>

The Indenture contains restrictive covenants which require, among other things, that the Company maintain specified levels of Consolidated Tangible Net Worth and Net Capital, each as defined. As of May 31, 2006, the Company was in compliance with all restrictive covenants.

The estimated fair value of the Company's subordinated liabilities, based on rates available to the Company at May 31, 2006 for debt with similar terms and maturities, was approximately \$4,765,612.

Morgan Stanley & Co. Incorporated

NOTE 6 -**Commitments and Contingencies****Office Facilities**

The Company has non-cancelable operating leases covering office space and equipment. At May 31, 2006, future minimum rental commitments under such leases were as follows:

<u>Fiscal Year</u>	<u>Amount</u>
2006	\$ 62,594
2007	124,943
2008	129,439
2009	112,217
2010	88,558
Thereafter	337,893
Total	<u>\$855,644</u>

Occupancy lease agreements, in addition to base rentals, generally provide for rent and operating expense escalations resulting from increased assessments for real estate taxes and other charges.

Letters of Credit

The Company had \$531,192 of letters of credit outstanding at May 31, 2006 to satisfy various collateral requirements.

Securities Activities

Financial instruments sold, not yet purchased represent obligations of the Company to deliver specified financial instruments at contracted prices, thereby creating commitments to purchase the financial instruments in the market at prevailing prices. Consequently, the Company's ultimate obligation to satisfy the sale of financial instruments sold, not yet purchased may exceed the amounts recognized in the consolidated statement of financial condition.

At May 31, 2006, the Company had commitments to enter into reverse repurchase and repurchase agreements of \$66,741,566 and \$18,671,013, respectively.

Legal

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

time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company's business including, among other matters, accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief. The number of these reviews, investigations and proceedings has increased in recent years with regard to many firms in the financial services industry, including the Company.

The Company contests liability and/or the amount of damages in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief might be. Subject to the foregoing, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of each such pending matter could be material to the Company's operating results for a particular future period, depending on, among other things, the level of the Company's revenues or income for such period. The Company also believes, except for the Coleman Litigation described below, that the outcome of each such pending matter will not have a material adverse effect on the consolidated financial condition of the Company. Legal reserves have been established in accordance with SFAS No. 5, "Accounting for Contingencies." Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

Coleman Litigation

On May 16, 2005, the jury in the litigation captioned *Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc.* ("Coleman litigation") returned a verdict in favor of Coleman (Parent) Holdings, Inc. ("CPH") with respect to its claims against the Company and awarded CPH \$604,000 in compensatory damages. On May 18, 2005, the jury awarded CPH an additional \$850,000 in punitive damages. On June 23, 2005, the state court of Palm Beach County, Florida entered its final judgment, awarding CPH \$208,000 for prejudgment interest and deducting \$84,000 from the award because of the settlements of related claims CPH entered into with others, resulting in a total judgment against the Company of \$1,578,000. On June 27, 2005, the Company filed a notice of appeal with the District Court of Appeal for the Fourth District of Florida and posted a supersedeas bond, which automatically

Morgan Stanley & Co. Incorporated

stayed execution of the judgment pending appeal. Included in cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements in the consolidated statement of financial condition, is \$1,862,847 of commercial paper and other securities which have been pledged to obtain the bond which was posted in this matter. The Company filed its initial brief in support of its appeal on December 7, 2005. The Company's appeal seeks to reverse the judgment of the trial court on several grounds and asks that the case be remanded for entry of a judgment in favor of the Company or, in the alternative, for a new trial. On June 28, 2006, the District Court of Appeal for the Fourth District of Florida heard oral argument on the Company's appeal from the judgment of the trial court.

The Company believes, after consultation with outside counsel, that it is probable that the compensatory and punitive damages awards will be overturned on appeal and the case remanded for a new trial. Taking into account the advice of outside counsel, the Company is maintaining a reserve of \$360,000 for the Coleman litigation, which it believes to be a reasonable estimate, under SFAS No. 5, "Accounting for Contingencies," of the low end of the range of its probable exposure in the event the judgment is overturned and the case remanded for a new trial. If the compensatory and/or punitive awards are ultimately upheld on appeal, in whole or in part, the Company may incur an additional expense equal to the difference between the amount affirmed on appeal (and post-judgment interest thereon) and the amount of the reserve. While the Company cannot predict with certainty the amount of such additional expense, such additional expense could have a material adverse effect on the consolidated financial condition of the Company where the upper end of the range could exceed \$1,200,000.

IPO Allocation Matters

In connection with the Company's role as either lead or co-lead underwriter in several initial public offerings ("IPO"), the Company has been exposed to both regulatory and civil proceedings. On January 25, 2005, the Company announced a settlement with the SEC regarding allegations that it violated Rule 101 of Regulation M by attempting to induce certain customers that received shares in IPOs to place purchase orders for additional shares in the aftermarket. Under the terms of the settlement, the Company agreed, without admitting or denying the allegations, to the entry of a judgment enjoining it from violating Rule 101 of Regulation M and the payment of a \$40,000 civil penalty. The court approved the settlement on February 4, 2005.

In addition to the above mentioned regulatory matter with the SEC, numerous purported class actions have been filed against certain issuers of IPO securities, certain individual officers of those issuers, the Company and other underwriters of those IPOs, purportedly on behalf of purchasers of stock in the IPOs or the aftermarket. These complaints allege that the Company required customers that wanted allocations of "hot" IPO securities to pay undisclosed and excessive underwriters' compensation in the form of increased brokerage commissions and to buy shares of securities offered in the IPOs after the IPOs were completed at escalating price levels higher than the IPO price (a practice plaintiffs refer to as "laddering"). Some of the complaints also allege that continuous "buy" recommendations by the defendants' research analyst improperly increased or sustained the prices at which the securities traded after the IPOs.

NOTE 7 - Trading Activities

Trading

The Company's trading activities are conducted through the integrated management of its client-driven and proprietary transactions, along with the hedging and financing of these positions. While trading activities are generated by client order flow, the Company also takes proprietary positions based on expectations of future market movements and conditions.

The Company's trading portfolios are managed with a view toward the risk and profitability of the portfolios. The following discussion of the nature of the equities and fixed income activities conducted by the Company, including the use of derivative products in these businesses, and risk management, the market risk, credit risk and concentration risk management policies and procedures covering these activities are discussed below.

Morgan Stanley & Co. Incorporated

Equities

The Company makes markets and trades in the global secondary markets for equities and is a dealer in exchange traded and OTC equity options, exchange traded funds and index futures. The Company's activities as a dealer primarily are client-driven, with the objective of meeting clients' needs while earning a spread between the premiums paid or received on its contracts with clients and the cost of hedging such transactions in the cash or forward market or with other derivative transactions. The Company limits its market risk related to these contracts, which stems primarily from underlying equity/index price and volatility movements, by employing a variety of hedging strategies. The Company also takes proprietary positions in the global equity markets by using derivatives, most commonly futures and options, in addition to cash positions, intending to profit from market price and volatility movements in the underlying equities or indices positioned.

The counterparties to the Company's equity transactions include commercial banks, investment banks, broker-dealers, investment funds and industrial companies.

Fixed Income

The Company makes markets and trades in fixed income securities and related products, including convertible debt, preferred stock, investment grade corporate debt, high-yield securities, U.S. government securities, municipal securities, and commercial paper, money market and other short-term securities. The Company also makes markets in, and acts as principal with respect to, mortgage-related and other asset-backed securities. In addition, the Company is a dealer in listed options on U.S. government bonds. The Company also takes positions in futures and options.

The Company also uses mortgage-backed forward agreements ("TBAs") in its role as a dealer in mortgage-backed securities and facilitates customer trades by taking positions in the TBA market. Typically, these positions are hedged by offsetting TBA contracts or underlying cash positions.

The Company is a market-maker in a number of foreign currencies. It actively trades currencies with its customers on a principal basis in the spot and forward markets earning a dealer spread. In connection with its market-making activities, the Company seeks to manage its market risk by entering into offsetting positions. The Company also takes proprietary positions in currencies to profit from market price and volatility movements in the currencies positioned.

The majority of the Company's foreign exchange business relates to major foreign currencies such as yen, euros, pound sterling, Swiss francs and Canadian dollars. The balance of the business covers a broad range of other currencies.

The counterparties to the Company's fixed income and foreign exchange transactions include investment advisors, commercial banks, insurance companies, investment banks, broker-dealers, investment funds and industrial companies.

Risk Management

The Company's risk management policies and related procedures are integrated with those of the Parent and its other consolidated subsidiaries. These policies and related procedures are administered on a coordinated global basis with consideration given to each subsidiary's, including the Company's, specific capital and regulatory requirements. For the discussion which follows, the term "Company" includes the Parent and its subsidiaries.

The cornerstone of the Company's risk management philosophy is protection of the Company's franchise and reputation. Guardianship is based on three key principles: accountability, transparency and independent oversight. Given the importance of effective risk management to the Company's reputation, senior management requires thorough and frequent communication and appropriate escalation of risk matters.

Risk management at the Company requires independent Company-level oversight, constant communication, judgment and knowledge of specialized products and markets. The Company's senior management takes an active role in the identification, assessment and management of various risks of the Company. In recognition of the increasingly varied and complex nature of the financial services business, the Company's risk management philosophy, with its attendant policies, procedures and methodologies, is evolutionary in nature and subject to ongoing review and modification.

The nature of the Company's risks, coupled with this risk management philosophy, informs the Company's risk governance structure. The Company's risk governance structure includes the Firm Risk Committee and the Capital Committee, the Chief Risk Officer, the Internal Audit Department, independent control groups and various risk control managers, committees and groups located within the business units.

Morgan Stanley & Co. Incorporated

The Firm Risk Committee, composed of the Company's most senior officers, oversees the Company's risk management structure. The Firm Risk Committee's responsibilities include comprehensive oversight of the Company's risk management principles, procedures and limits, and monitoring of material financial, operational and franchise risks. The Firm Risk Committee is overseen by the Audit Committee of the Board of Directors (the "Audit Committee"). The Capital Committee oversees alignment of the Company's resource allocation with strategic priorities. The Capital Committee's responsibilities include: directing capital to the business units; approving technical capital recommendations; approving capital exceptions; and approving methodologies for capital allocation for the Company and the business units.

The Chief Administrative and Risk Officer, a member of the Firm Risk Committee, oversees compliance with Company risk limits, approves certain excessions of Company risk limits, reviews material market, credit and liquidity and funding risks, and reviews results of risk management processes with the Audit Committee.

The Internal Audit Department provides independent risk and control assessment and reports to the Audit Committee and administratively to the Chief Legal Officer. The Internal Audit Department periodically examines the Company's operational and control environment and conducts audits designed to cover all major risk categories.

The Market Risk, Credit, Financial Control, Treasury and Law Departments (collectively, the "Company Control Groups"), which are all independent of the Company's business units, assist senior management and the Firm Risk Committee in monitoring and controlling the Company's risk through a number of control processes. The Company is committed to employing qualified personnel with appropriate expertise in each of its various administrative and business areas to implement effectively the Company's risk management and monitoring systems and processes.

Each business unit has a Risk Committee which is responsible for ensuring that the business unit, as applicable: adheres to established limits for market, credit and other risks; implements risk measurement, monitoring and management policies and procedures that are consistent with the risk framework established by the Firm Risk Committee; and reviews, on a periodic basis, its aggregate risk exposures, risk exception experience and the efficacy of its risk identification, measurement, monitoring and management policies and procedures, and related controls.

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 Company manages the market risk associated with its trading activities on a Company-wide basis, on a trading division level and on an individual product basis. Aggregate market risk limits have been approved for the Company and for each major trading division. Additional market risk limits are assigned to trading desks and, as appropriate, products. 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 Company's trading portfolios on a regular basis from a market risk perspective utilizing Value-at-Risk and other quantitative and qualitative risk measures and analyses. The Company'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. 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 analyses, which estimate the Company's revenue sensitivity to a set of specific, predefined market and geopolitical events.

Credit Risk

The Company's exposure to credit risk arises from the possibility that a customer or counterparty to a transaction might fail to perform under its contractual commitment, which could result in the Company incurring losses. The Company has credit guidelines that limit the Company's current and potential credit exposure to any one customer or counterparty and to aggregates of customers or counterparties by type of business activity. Specific credit risk limits based on these credit guidelines also are in place for each type of customer or counterparty (by rating category).

The Credit Department administers limits, monitors credit exposure, and periodically reviews the financial soundness of customers and counterparties. The Company manages the credit exposure relating to its trading activities in various ways,

Morgan Stanley & Co. Incorporated

including entering into master netting agreements, collateral arrangements, and limiting the duration of exposure. Risk is mitigated in certain cases by closing out transactions, entering into risk reducing transactions, assigning transactions to other parties, or purchasing credit protection.

Concentration Risk

The Company is subject to concentration risk by holding large positions in certain types of securities or commitments to purchase securities of a single issuer, including sovereign governments and other entities, issuers located in a particular country or geographic area, public and private issuers involving developing countries, or issuers engaged in a particular industry. Financial instruments owned by the Company include U.S. government and agency securities, which, in the aggregate, represented approximately 3% of the Company's total assets at May 31, 2006. In addition, substantially all of the collateral held by the Company for reverse repurchase agreements or bonds borrowed, which together represented approximately 31% of the Company's total assets at May 31, 2006, consist of securities issued by the U.S. government, federal agencies or other sovereign government obligations. Positions taken and commitments made by the Company, including positions taken and underwritings, often involve substantial amounts and significant exposure to individual issuers and businesses, including non-investment grade issuers. The Company seeks to limit concentration risk through the use of the systems and procedures described in the preceding discussions of risk management, market risk and credit risk.

Customer Activities

The Company's customer activities involve the execution, settlement and financing of various securities and commodities transactions on behalf of customers. Customer securities activities are transacted on either a cash or margin basis. Customer commodities activities, which include the execution of customer transactions in commodity futures transactions (including options on futures), are transacted on a margin basis.

The Company's customer activities may expose it to off-balance sheet credit risk. The Company may have to purchase or sell financial instruments at prevailing market prices in the event of the failure of a customer to settle a trade on its original terms or in the event cash and securities in customer margin accounts are not sufficient to fully cover customer losses. The Company seeks to control the risks associated with customer activities by requiring customers to maintain margin collateral in compliance with various regulations and Company policies.

Fair Value of Derivatives

In the normal course of business, the Company enters into a variety of derivative contracts related to financial instruments. The Company uses forward and option contracts and futures in its trading activities. In addition, financial futures and forward contracts are actively traded by the Company and are used to hedge proprietary inventory. The Company also enters into delayed delivery, when-issued, warrant and option contracts involving securities. These instruments generally represent future commitments to exchange currencies or purchase or sell other financial instruments on specific terms at specified future dates. Certain of these products have maturities that do not extend beyond one year, while options and warrants on equities may have longer maturities.

The fair value (carrying amount) of derivative instruments represents the amount at which the derivative could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale and is further described in NOTE 2. Future changes in interest rates, foreign currency exchange rates or the fair values of the financial instruments or indices underlying these contracts ultimately may result in cash settlements exceeding fair value amounts recognized in the consolidated statement of financial condition. The amounts in the following table represent unrealized gains on purchased exchange-traded and OTC options and other contracts (including foreign exchange and other forward contracts) used by the Company for trading, net of any unrealized losses owed to the counterparties on offsetting positions in situations where netting is appropriate. These amounts are not reported net of collateral, which the Company obtains with respect to certain of these transactions to reduce its exposure to credit losses.

Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the contracts reported as assets. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary. The Company believes the ultimate settlement of the transactions outstanding at May 31, 2006 will not have a material effect on the Company's consolidated statement of financial condition.

The credit quality of the Company's trading-related derivatives (both listed and OTC) at May 31, 2006 is summarized in the table below, showing the fair value of the related assets by counterparty credit rating. The actual credit ratings are

Morgan Stanley & Co. Incorporated

determined by external rating agencies or by equivalent ratings used by the Parent's Credit Risk Department:

<u>(In millions of dollars)</u>	<u>AAA</u>	<u>AA</u>	<u>A⁽¹⁾</u>	<u>BBB</u>	<u>B</u>	<u>Other Non Investment Grade</u>	<u>Total</u>
Fixed income securities contracts (including forward contracts and options)	\$ 15	\$ -	\$ 15	\$ -	\$ -	\$ -	\$ 30
Foreign exchange forward contracts	89	1,381	643	485	-	1,383	3,981
Equity securities contracts (including warrants and options)	1,312	-	62	-	112	8	1,494
Total	<u>\$1,416</u>	<u>\$1,381</u>	<u>\$720</u>	<u>\$485</u>	<u>\$112</u>	<u>\$1,391</u>	<u>\$5,505</u>
Percent of total	<u>26%</u>	<u>25%</u>	<u>13%</u>	<u>9%</u>	<u>2%</u>	<u>25%</u>	<u>100%</u>

⁽¹⁾ Includes approximately \$538 of derivative transactions with affiliates.

NOTE 8 - Variable Interest Entities

Financial Accounting Standards Board ("FASB") Interpretation No. 46, as revised ("FIN 46R"), "Consolidation of Variable Interest Entities" applies to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties ("variable interest entities"). Variable interest entities ("VIEs") are required to be consolidated by their primary beneficiaries if they do not effectively disperse risks among parties involved. The primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests. The Company is involved with various entities in the normal course of business that may be deemed to be VIEs and may hold interests therein that may be considered variable interests. Transactions associated with these entities include asset and mortgage-backed securitizations, credit-linked notes and other structured financings (including collateralized debt or bond obligations). The Company engages in these transactions principally to facilitate client needs and as a means of selling financial assets. The Company consolidates entities in which it has a controlling financial interest in accordance with accounting principles generally accepted in the U.S. For those entities deemed to be qualifying special purpose entities (as defined in SFAS No. 140), the Company does not consolidate the entity.

The Company purchases and sells interests in entities that may be deemed to be VIEs in the ordinary course of its business. As a result of these activities, it is possible that such entities may be

consolidated and deconsolidated at various points in time. Therefore, the Company's variable interests included below may not be held by the Company at the end of future reporting periods.

At May 31, 2006, the aggregate size of VIEs, including structured note entities, financial asset-backed securitization, collateralized debt obligation and credit-linked note entities, for which the Company was the primary beneficiary of the entities was approximately \$1,397,389, which is the carrying amount of the consolidated assets recorded as financial instruments owned that are collateral for the entities' obligations. The nature and purpose of these entities that the Company consolidated were to issue a series of notes to investors that provide the investors a return based on the holdings of the entities. These transactions were executed to facilitate client investment objectives. Certain credit-linked note and certain financial asset-backed securitization transactions also were executed as a means of selling financial assets. The Company holds either the entire class or a majority of the class of subordinated notes or entered into a derivative instrument with the VIE and as a result bears the majority of the expected losses or receives a majority of the expected residual returns of the entities. The Company consolidates these entities, in accordance with its consolidation accounting policy, and as a result eliminates all intercompany transactions, including derivatives and other intercompany transactions such as fees received to underwrite the notes or to structure the transactions. The Company accounts for the assets held by the entities as financial instruments owned and the liabilities of the entities as other secured financings. For those liabilities that include an embedded derivative, the Company has bifurcated such derivative in accordance with SFAS No. 133, as amended by SFAS No. 149. The beneficial interests of these consolidated entities are payable solely from the cash flows of the assets held by the VIE.

At May 31, 2006, the aggregate size of the entities for which the Company holds significant variable interests, was approximately \$838,740. The Company's variable interests associated with these entities, primarily credit-linked notes and financial asset-backed entities, were approximately \$293,604 consisting primarily of senior beneficial interests, which represent the Company's maximum exposure to loss at May 31, 2006. The Company may hedge the risks inherent in its variable interest holdings, thereby reducing its exposure to loss. The Company's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company utilizes to hedge these risks.

Morgan Stanley & Co. Incorporated

**NOTE 9 -
Guarantees**

The Company has certain obligations under certain guarantee arrangements, including contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or nonoccurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. Also included as guarantees are contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement as well as indirect guarantees of the indebtedness of others.

Derivative Contracts

Certain derivative contracts meet the accounting definition of a guarantee, including certain written options and contingent forward contracts. Although the Company's derivative arrangements do not specifically identify whether the derivative counterparty retains the underlying asset, liability or equity security, the Company has disclosed information regarding all derivative contracts that could meet the accounting definition of a guarantee. The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated as increases in interest or foreign exchange rates in the future could possibly be unlimited. In order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed.

The Company records all derivative contracts at fair value. For this reason, the Company does not monitor its risk exposure to such derivative contracts based on derivative notional amounts; rather the Company manages its risk exposure on a fair value basis. Aggregate market risk limits have been established and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies including, but not limited to, entering into offsetting economic hedge positions. The Company records all derivative contracts on its consolidated statement of financial condition at fair value and believes that the notional amounts of the derivative contracts generally overstate its exposure. For further discussion of the Company's derivative risk management activities see NOTE 7.

Financial Guarantees to Third Parties

In connection with a funding transaction, the Company provides a financial guarantee to a third party of its affiliate's contractual obligation to repay. Such arrangement represents an obligation to make a payment to a third party if the counterparty fails to fulfill its obligation under a borrowing arrangement or other contractual obligation. The Company has the ability to offset any amount it is required to pay under the financial guarantee with an obligation owed to its affiliate's parent.

The table below summarizes certain information regarding these guarantees at May 31, 2006:

	Maximum Potential Payout/Notional							
	Years to Maturity				Total	Carrying Amount	Collateral	
Type of Guarantee	Less than 1	1-3	3-5	Over 5				
Derivative contracts	\$27,774,332	\$2,157,432	\$103	\$ –	\$29,931,867	\$1,371	–	
Financial guarantee	50	–	–	100	150	–	–	

Exchange/Clearinghouse Member Guarantees

The Company is a member of various U.S. exchanges and clearinghouses that trade and clear securities and/or futures contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse. While the rules governing different exchange or clearinghouse memberships vary, in general the Company's guarantee obligations would arise only if the exchange or clearinghouse had previously exhausted its resources. In addition, any such guarantee obligation would be apportioned among the other non-defaulting members of the exchange or clearinghouse. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the consolidated statement of financial condition for these agreements and believes that any potential requirement to make payments under these agreements is remote.

**NOTE 10 -
Employee Compensation Plans**

Employees of the Company participate in compensation plans sponsored by the Parent. The following summarizes these plans:

Equity-Based Compensation Plans

Certain employees of the Company participate in several of the Parent's equity-based stock compensation plans. The Company records compensation expense based upon the fair value of

Morgan Stanley & Co. Incorporated

stock-based awards. In fiscal 2005, the parent early adopted SFAS No. 123R “Shared-Based Payment,” which revised the fair value based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarified guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to service periods.

For stock-based awards issued prior to the adoption of SFAS 123R, the Company’s accounting policy for such awards granted to retirement-eligible employees was to recognize compensation cost over the service period specified in the award terms. The Company accelerates any unrecognized compensation cost if and when a retirement-eligible employee leaves the Company. For stock-based awards made to retirement-eligible employees after the adoption of SFAS 123R, the Company’s accounting policy is to treat such awards as fully vested on the date of grant, unless other provisions of the award terms operate as substantive service provisions. For awards granted to retirement-eligible employees during fiscal 2005, compensation expense for such awards was recognized on the date of grant.

401(k) and Profit Sharing Plans

Eligible employees receive 401(k) matching contributions which are invested in the Company’s common stock. The Company also provides discretionary profit sharing to certain employees.

**NOTE 11 -
Employee Benefit Plans**

The Company sponsors various pension plans for the majority of its employees and employees of certain U.S. affiliates. The Company provides certain other postretirement benefits, primarily health care and life insurance, to eligible employees. The Company also provides certain benefits to former employees or inactive employees prior to retirement. The following summarizes these plans:

Pension and Postretirement Benefit Plans

Substantially all of the employees of the Company and its U.S. affiliates are covered by a non-contributory pension plan that is qualified under Section 401(a) of the Internal Revenue Code (the “Qualified Plan”). Unfunded supplemental plans (the “Supplemental Plans”) cover certain executives. These pension plans generally provide pension benefits that are based on each employee’s years of credited service and on compensation levels specified in the plans. For the Qualified Plan, the Company’s policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable

employee benefit and tax regulations. Liabilities for benefits payable under the Supplemental Plans are accrued by the Company and are funded when paid to the beneficiaries.

The Company also has unfunded postretirement benefit plans that provide medical and life insurance for eligible retirees and dependents.

The Company used a measurement date of September 30, 2005 for its pension and postretirement plans. The following tables present information for the Company’s pension and postretirement plans:

Benefit Obligation and Funded Status

The following table provides a reconciliation of the changes in the benefit obligation and fair value of plan assets for fiscal 2005 as well as a summary of the funded status of the plans as of November 30, 2004:

	Pension Plan	Postretirement Plan
Reconciliation of projected benefit obligation:		
Benefit obligation at beginning of year	\$701,799	\$114,482
Service cost	36,790	6,099
Interest cost	42,016	6,838
Actuarial loss	51,520	(4,656)
Benefits paid and settlements	(14,007)	(3,010)
Plan amendments	393	-
Projected benefit obligation at end of year	<u>818,511</u>	<u>119,753</u>
Reconciliation of fair value of plan assets:		
Fair value of plan assets at beginning of year	502,973	-
Actual return on plan assets	56,322	-
Employer contributions	90,492	3,010
Benefits paid	(14,007)	(3,010)
Fair value of plan assets at end of year	<u>635,780</u>	<u>-</u>
Funded status:		
Funded (unfunded) status	(182,731)	(119,753)
Unrecognized prior-service cost	(59,694)	(1,921)
Unrecognized loss	225,730	31,441
Amount contributed to plan after measurement date	971	-
Net amount recognized	<u>\$(15,724)</u>	<u>\$(90,233)</u>

The accumulated benefit obligation was \$777,339 at November 30, 2005.

Morgan Stanley & Co. Incorporated

Assumptions

The following table presents the weighted average assumptions used to determine benefit obligations at fiscal year-end:

	<u>Pension</u> <u>Fiscal 2005</u>	<u>Postretirement</u> <u>Fiscal 2005</u>
Discount rate	5.75%	5.75%
Rate of future compensation increases	4.74%	n/a

The following table presents the weighted average assumptions used to determine net periodic benefit costs for fiscal 2005:

	<u>Pension</u> <u>Fiscal 2005</u>	<u>Postretirement</u> <u>Fiscal 2005</u>
Discount rate	6.05%	6.05%
Expected long-term rate of return on plan assets	7.00%	n/a
Rate of future compensation increases	4.80%	n/a

The Company uses the expected long-term rate of return on plan assets to compute the expected return on assets. For its Qualified Plan, which comprised approximately 92% of the total assets of the Company's pension plans at November 30, 2005, the Company annually reviews the expected long-term return based on changes in the target investment mix and economic environment from the previous year. It then compares its initial estimate (and adjusts, if necessary) with a portfolio return calculator model (the "Portfolio Model") the produces a range of expected returns for the portfolio. Return assumptions are forward-looking gross returns that are not developed solely by an examination of historical returns. The Portfolio Model begins with the current U.S. Treasury yield curve, recognizing that expected returns on bonds are heavily influenced by the current level of yields. Corporate bond spreads and equity risk premiums, based on current market conditions, are then added to develop the return expectations for each asset class. Expenses that are expected to be paid from the investment return are reflected in the Portfolio Model as a percentage of plan assets. This includes investment and transaction fees that typically are paid from plan assets, added to the cost basis or subtracted from sale proceeds, as well as administrative expenses paid from the pension plan.

The following table presents assumed health care cost trend rates:

	<u>November 30,</u> <u>2005</u>
Health care cost trend rate assumed for next year:	
Medical	10.0%
Prescription	14.0%
Rate to which the cost trend rate is assumed to decline (ultimate trend rate)	5.0%
Year that the rate reaches the ultimate trend rate	2012

Assumed health care cost trend rates can have a significant effect on the amounts reported for the Company's postretirement benefit plans. A one-percentage point change in assumed health care cost trend rates would have the following effects:

	<u>One Percentage</u> <u>Point Increase</u>	<u>One Percentage</u> <u>Point Decrease</u>
Effect on postretirement benefit obligation	\$23,645	\$ (18,233)

Plan Assets

The weighted average asset allocations for the Company's qualified plans at November 30, 2005 and the targeted asset allocation for fiscal 2006 by asset class were as follows:

	<u>November 30,</u> <u>2005</u>	<u>Fiscal 2006</u> <u>Targeted</u>
Equity securities	47%	45%
Fixed income securities	43%	55%
Other—primarily cash	10%	-%
Total	100%	100%

Pension Plan Asset Allocation

The Company, in consultation with its independent investment consultants and actuaries, determined the asset allocation targets for its Qualified Plan based on its assessment of business and financial conditions, demographic and actuarial data, funding characteristics and related risk factors. Other relevant factors, including industry practices, long-term historical and prospective capital market returns, were considered as well.

The Qualified Plan return objectives provide long-term measures for monitoring the investment performance against growth in the pension obligations. The overall allocation is expected to help protect the plan's funded status while generating sufficiently stable real returns (net of inflation) to

Morgan Stanley & Co. Incorporated

help cover current and future benefit payments. Total Qualified Plan portfolio performance is assessed by comparing actual returns with relevant benchmarks, such as the S&P 500 Index, the Russell 2000 Index, the MSCI EAFE Index and, in the case of the fixed income portfolio, the Qualified Plan's liability profile.

Both the equity and fixed income portions of the asset allocation use a combination of active and passive investment strategies and different investment styles. The fixed income asset allocation consists of longer duration fixed income securities in order to help reduce plan exposure to interest rate variation and to better correlate assets with obligations. The longer duration fixed income allocation is expected to help stabilize plan contributions over the long run.

The asset mix of the Company's Qualified Plan is reviewed by the Morgan Stanley Retirement Plan Investment Committee on a regular basis. When asset class exposure reaches a minimum or maximum level, an asset allocation review process is initiated and the portfolio is automatically rebalanced back to target allocation levels, unless the Investment Committee determines otherwise.

The Morgan Stanley Retirement Plan Investment Committee has determined to allocate no more than 10% of the Qualified Plan assets to "alternative" asset classes that provide attractive diversification benefits, absolute return enhancement and/or other potential benefit to the plan. Allocations to alternative asset classes will be made based upon an evaluation of particular attributes and relevant considerations of each asset class.

Derivative instruments are permitted in the Qualified Plan's portfolio only to the extent that they comply with all of the plan's policy guidelines and are consistent with the plan's risk and return objectives. In addition, any investment in derivatives must meet the following conditions:

- Derivatives may be used only if the vehicle is deemed by the investment manager to be more attractive than a similar direct investment in the underlying cash market; or if the vehicle is being used to manage risk of the portfolio.
- Under no circumstances may derivatives be used in a speculative manner or to leverage the portfolio.
- Derivatives may not be used as short-term trading vehicles. The investment philosophy of the Plan is that investment activity is undertaken for long-term investment, rather than short-term trading.

- Derivatives may only be used in the management of the Qualified Plan's portfolio when their possible effects can be quantified, shown to enhance the risk-return profile of the portfolio and reported in a meaningful and understandable manner.
- As a fundamental operating principle, any restrictions on the underlying assets apply to a respective derivative product. This includes percentage allocations and credit quality. The purpose of the use of derivatives is to enhance investment in the underlying assets, not to circumvent portfolio restrictions.

Cash Flows

The Company expects to contribute approximately \$44,817 to its pension and postretirement benefit plans in fiscal 2006 based upon their current funded status and expected asset return assumptions for fiscal 2006, as applicable.

Expected benefit payments associated with the Company's pension and postretirement benefit plans for the next five fiscal years and in aggregate for the five fiscal years thereafter are as follows:

	<u>Pension</u>	<u>Postretirement</u>
Fiscal 2006	\$17,468	\$3,211
Fiscal 2007	19,238	3,488
Fiscal 2008	21,099	3,738
Fiscal 2009	23,336	4,036
Fiscal 2010	25,503	4,403
Fiscal 2011-2015	166,112	27,506

NOTE 12 - Income Taxes

The Company is included in the consolidated federal income tax return filed by the Parent. Federal income taxes have been provided on a separate entity basis. The Company is included in the combined state and local income tax returns with the Parent and certain other subsidiaries of the Parent. State and local income taxes have been provided on separate entity income at the effective tax rate of the Company's combined filing group.

In accordance with the terms of the Tax Allocation Agreement with the Parent, all current and deferred taxes are offset with all other intercompany balances with the Parent.

Deferred income taxes reflect the net tax effects of temporary differences between the financial reporting and tax bases of assets and liabilities and are primarily attributable to employee benefit plan payables.

Morgan Stanley & Co. Incorporated

Income Tax Examinations

The Company, through its inclusion on the Parent's returns, is under continuous examination by the Internal Revenue Service (the "IRS") and other state tax authorities in certain countries and states in which the Company has significant business operations, such as New York. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1999-2004. The parent has filed an appeal with respect to unresolved issues relative to the IRS examination of years 1994-1998. The parent believes that the settlement of the IRS examination of years 1998-1998 will not have a material impact on the condensed consolidated statement of income of the Parent. The Parent regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years' examinations. The Parent has established tax reserves that the Parent believes are adequate in relation to the potential for additional assessments. Once established, the Parent adjusts tax reserves only when more information is available or when an event occurs necessitating a change to the reserves. The Company believes that the resolution of tax matters will not have a material effect on the consolidated financial condition of the Company.

**NOTE 13 -
Regulatory Requirements**

MS&Co. is a registered broker-dealer and futures commission merchant and, accordingly, is subject to the Net Capital rules of the SEC, the CFTC and the New York Stock Exchange ("NYSE"). Under these rules, MS&Co. is required to maintain minimum Net Capital of not less than the greater of 2% of aggregate debit items arising from customer transactions, as defined, plus excess margin collateral on reverse repurchase agreements or the risk based requirement representing the sum of 8% of customer risk maintenance margin requirement and 4% of non customer risk maintenance margin requirement, as defined. The NYSE may require a member firm to reduce its business if net capital is less than 4% of such aggregate debit items and may prohibit a firm from expanding its business if net capital is less than 5% of such aggregate debit items. At May 31, 2006, MS&Co.'s Net Capital was \$4,762,009, which exceeded the minimum requirement by \$3,721,214 and included excess Net Capital of \$802,103 of MS Securities Services Inc., a registered broker-dealer and a guaranteed subsidiary of MS&Co.

Advances to the Parent and its affiliates, repayment of subordinated liabilities, dividend payments and other equity withdrawals are subject to certain notification and other provisions of the Net Capital rules of the SEC.

Regulatory Developments

In June 2004, the SEC issued rules that permit certain highly capitalized broker-dealers that are part of a consolidated supervised entity ("CSE") to apply to the SEC for approval to use an alternative method for calculating net capital charges (the "CSE Rules"). To obtain approval to calculate capital under the alternative method in the CSE Rules, a broker-dealer's holding company must consent, on a voluntary basis, to group-wide supervision and examination by the SEC and must have in place group-wide internal risk management controls and calculate capital in a manner generally consistent with the standards of the Basel Committee on Banking Supervision ("Basel II"). The CSE Rules are intended to reduce regulatory capital costs for qualifying firms by permitting such firms to use proprietary mathematical risk measurement models for regulatory capital computation and internal control purposes.

On July 28, 2005, the SEC approved the application by the Company for authorization to use, effective December 1, 2005, the alternative method of computing net capital set forth in the CSE Rules. The approval, allows MS&Co. to use an alternative method based on mathematical models to calculate net capital charges for market and derivatives-related credit risk. The Company began reporting as a CSE effective December 1, 2005.

Morgan Stanley & Co. Incorporated

Morgan Stanley Principal Locations

New York

(World Headquarters)
1585 Broadway
New York, New York 10036
Telephone: (212) 761-4000
Fax: (212) 761-0086

Amsterdam

Rembrandt Tower, 11th Floor
Amstelplein 1, 1096 HA Amsterdam
The Netherlands
Telephone: (31 20) 462-1300
Fax: (31 20) 462-1310

Athens

18 Valaoritou Street
Athens, Greece 10671
Telephone: (31 20) 364-0468
Fax: (31 20) 364-0538

Atlanta

Pinnacle Building
3455 Peachtree Road Northeast
Atlanta, Georgia 30326
Telephone: (404) 949-4100
Fax: Varies by Division

Austin

6300 Bridgepoint Parkway
Suite 125
Austin, TX 78730
Telephone: (512) 478-7800
Fax: (512) 478-9672

Bangkok

9th Floor, Diethelm Tower A
93/1 Wireless Road
Bangkok 10330, Thailand
Telephone: (66 2) 627-3300
Fax: (66 2) 627-3311

Beijing

Room 2706
China World Tower II
China World Trade Center
No. 1 Jian Guo Man Wai Dajie
Beijing 100004
People's Republic of China
Telephone: (86 10) 6505-8383
Fax: (86 10) 6505-8220/1

Boston

Two International Place, 23rd Floor
Boston, Massachusetts 02110
Telephone: (617) 856-8700
Fax: (617) 856-8019

Buenos Aires

Avenida Alicia Moreau de Justo 740
2do. Piso, Oficina 6
1107 — Buenos Aires, Argentina
Telephone: (54 11) 4349-0700
Fax: (54 11) 4349-0707

Chicago

440 South La Salle Street
Chicago, Illinois 60605
Telephone: (312) 706-4000
Fax: (312) 706-4710

Van Kampen Investments

1 Parkview Plaza
Oakbrook Terrace, IL 60181
Telephone: (630) 684-6000
Fax: (630) 684-5997

Frankfurt

Junghofstraße 13-15
60311 Frankfurt am Main, Germany
Telephone: (49 69) 2166-0
Fax: (49 69) 2166-2099

Geneva

12 Place de la Fusterie
1204 Geneva, Switzerland
Telephone: (41 22) 319-8000
Fax: (41 22) 319-8033

Hong Kong

30th Floor, 3 Exchange Square
Central, Hong Kong, SAR
Telephone: (85 2) 2848-5200
Fax: (85 2) 2845-1012

Houston

Chase Tower, 600 Travis, Suite 3700
Houston, Texas 77002-2993
Telephone: (713) 512-4400
Fax: (713) 512-4559

Johannesburg

1st Floor S.W. Wing
160 Jan Smuts Avenue
Rosebank, 2196
South Africa
Telephone: (27 11) 507-0800
Fax: (27 11) 507-0801

London

25 Cabot Square, Canary Wharf
London, E14 4QA England
Telephone: (44 20) 7425-8000
Fax: (44 20) 7425-8990

Los Angeles

1999 Avenue of the Stars, Suite 2400
Los Angeles, California 90067
Telephone: (310) 788-2000
Fax: (310) 788-2048

Luxembourg

6B, Route de Treves
L-2633 Senningerberg
Luxembourg
Telephone: (352) 3464-6000
Fax: (352) 3464-6363

Madrid

c/Serrano 55
28006 Madrid, Spain
Telephone: (34 91) 700-7200
Fax: (34 91) 700-7299

Melbourne

Level 53, 101 Collins Street
Melbourne, Victoria, 3000, Australia
Telephone: (613) 9256-8900
Fax: (613) 9256-8951

Menlo Park

3000 Sand Hill Road
Bldg. 4, Suite 250
Menlo Park, CA 94025
Telephone: (650) 233-2500
Fax: (650) 233-2626

Mexico City

Andrés Bello 10, 8° Piso
Colonia Polanco
11560, México, D.F.
Telephone: (525) 282-6700
Fax: (525) 282-9200

Morgan Stanley & Co. Incorporated

Milan

Palazzo Serbelloni
Corso Venezia, 16
20121 Milan, Italy
Telephone: (39 02) 763-31
Fax: (39 02) 783-057

Montreal

1000 de la Guachetiere
Suite 2402
Montreal, Quebec, Canada
H3B 4W5
Telephone: (514) 847-7400
Fax: (514) 847-7429

Moscow

Ducat Plaza II, 7 Gasheka Street
Moscow 123056, Russia
Telephone: (7 501) 785-2200
Fax: (7 501) 785-2229

Mumbai

Forbes Building
Charanjit Rai Marg
Mumbai 400 001, India
Telephone: (91 22) 2209-6600
Fax: (91 22) 2209-6601/02

Morgan Stanley France

61 , rue de Monceau
75008, Paris
France

Morgan Stanley France

26 rue de Monceau
75008 Paris
France
Telephone: (331) 5377-7000
Fax: (331) 5377-7099

Philadelphia

Morgan Stanley Investment
Management
1 Tower Bridge, Suite 1100
West Conshohocken, PA 19428-2899
Telephone: (610) 940-5000
Fax: (610) 260-7093

San Francisco

555 California Street, Suite 2200
San Francisco, California 94104
Telephone: (415) 576-2000
Fax: Varies by Division

Morgan Stanley Investments LP
580 California Street, Suite 2050
San Francisco, California 94104
Telephone: (415) 397-6565
Fax: (415) 397-6405

São Paulo

Edifício CBS
Av. Pres. Juscelino Kubitschek
50-8º Andar
04543-000 São Paulo-SP
Brazil
Telephone: (55 11) 3048-6000
Fax: (55 11) 3048-6099

Seoul

19th Floor, Kwanghwamoon Building
211-1, 1-Ka, Sejongro, Chongro-Ku
Seoul 110-730, Korea
Telephone: (822) 399-4848
Fax: (822) 399-4827

Shanghai

Suite 700B, 7th Floor, West Wing
Shanghai Center
1376 Nan Jing Xi Lu
Shanghai 200040
People's Republic of China
Telephone: (86 21) 6279-7150
Fax: (86 21) 6279-7157

Singapore

23 Church Street
#16-01 Capital Square
Singapore, 049481
Telephone: (65) 6834-6888
Fax: (65) 6834-6806

Stockholm

Hovslagargatan 5A
111 48 Stockholm, Sweden
Telephone: (46 8) 678-9600
Fax: (46 8) 678-9601

Sydney

Level 33, The Chifley Tower
2 Chifley Square
Sydney, NSW 2000, Australia
Telephone: (612) 9770-1111
Fax: (612) 9770-1101

Taipei

22nd Floor, Taipei Metro
207 Tun Hwa South Road, Sec. 2
Taipei 106, Taiwan
Telephone: (88 62) 2730-2800
Fax: (88 62) 2730-2810

Tel Aviv

Millennium Tower
19th Floor
17 Ha'arba'a Street South Kiryah
Tel Aviv, Israel 64739
Telephone: (972 3) 623-6300
Fax: (972 3) 623-6399

Tokyo

Yebisu Garden Place Tower
20-3, Ebisu 4-Chome
Shibuya-Ku, Tokyo 150-6008
Japan
Telephone: (813) 5424-5000
Fax: (813) 5424-5099

Toronto

BCE Place, 181 Bay Street
Suite 3700
Toronto, Ontario
Canada M5J 2T3
Telephone: (416) 943-8400
Fax: (416) 943-8444

Zurich

Bahnhofstrasse 92
CH-8023 Zurich, Switzerland
Telephone: (411) 220-9111
Fax: (411) 220-9800

Securities and cash held in Morgan Stanley & Co. Incorporated accounts are protected up to their full net equity value by a combination of coverage provided by the Securities Investor Protection Corporation ("SIPC") a non-profit organization created by an Act of Congress and additional protection purchased from a private insurer by Morgan Stanley & Co. Incorporated (the "Excess Coverage"). SIPC protects up to \$500,000 of each customer's securities of which up to \$100,000 may be uninvested cash. Excess Coverage provides additional protection up to the full net equity value of each account including unlimited coverage for uninvested cash. SIPC and Excess Coverage apply only to securities and cash in the exclusive possession and control of Morgan Stanley Co. Incorporated and do not protect against losses due to market fluctuations. If you would like more information, ask your Financial Advisor for a detailed brochure.

© 2006 Morgan Stanley

