

Morgan Stanley DW Inc.

# Consolidated Statement of Financial Condition

(Unaudited) May 31, 2005

Investments and services are offered through Morgan Stanley DW Inc., member SIPC.

## Morgan Stanley DW Inc. Consolidated Statement of Financial Condition

May 31, 2005 (Unaudited)  
(In thousands of dollars except share data)

### Assets

Cash	\$324,426
Cash and securities deposited with clearing organizations or segregated under federal and other regulations (securities at fair value of \$3,549,502)	3,637,993
Financial instruments owned (\$153,430 was pledged to various parties):	
U.S. government and federal agency	595,065
Corporate and other debt	1,035,042
Corporate equities	143,720
Securities purchased under agreements to resell	2,127,461
Securities borrowed	629,600
Receivables:	
Customers (net of allowances of \$13,499)	4,434,235
Brokers, dealers and clearing organizations	91,939
Office facilities, at cost (less accumulated depreciation and amortization of \$461,698)	178,146
Other assets	869,537
Total assets	<u>\$14,067,164</u>

### Liabilities and Stockholder's Equity

Financial instruments sold, not yet purchased:	
U.S. government and federal agency	\$571,057
Corporate and other debt	371,107
Corporate equities	26,237
Collateralized Financings:	
Securities sold under agreements to repurchase	2,148,151
Securities loaned	948,428
Payables:	
Customers	5,030,292
Brokers, dealers and clearing organizations	97,169
Affiliates	959,664
Other liabilities and accrued expenses	1,403,341
	<u>11,555,446</u>
Subordinated liabilities	<u>750,000</u>
Stockholder's equity:	
Common stock (\$1 par value, 11,000 shares authorized, issued and outstanding)	11
Paid-in capital	769,715
Retained earnings	991,992
Total stockholder's equity	<u>1,761,718</u>
Total liabilities and stockholder's equity	<u>\$14,067,164</u>

See Notes to Consolidated Statement of Financial Condition.

## Morgan Stanley DW Inc. Notes to Consolidated Statement of Financial Condition

As of May 31, 2005 (Unaudited)  
(In thousands of dollars, except share data)

### Note 1—Introduction and Basis of Presentation

#### The Company

Morgan Stanley DW Inc. ("MSDW"), together with its wholly owned subsidiaries serves the investment needs of its customers by providing a wide range of investment products and services through its sales organization located throughout the United States. MSDW and certain of its subsidiaries are registered with the Securities and Exchange Commission ("SEC") as broker-dealers. MSDW 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 valuation of certain financial instruments, the potential outcome of litigation and other matters that affect the consolidated financial statement and related disclosures. The Company believes that the estimates utilized in the preparation of the consolidated financial statement are prudent and reasonable. Actual results could differ materially from these estimates.

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

#### Related Party Transactions

The Company has transactions with the Parent and affiliates, including lease arrangements, the performance of administrative services, underwriting, mutual fund distribution, research activities and the execution of securities transactions with and on behalf of affiliates.

At May 31, 2005, balances with affiliates included securities borrowed and securities purchased under agreements to resell ("reverse repurchase agreements") of \$629,599 and \$618,163, respectively, and securities loaned of \$914,566 and securities sold under agreements to repurchase ("repurchase agreements") of \$55,688.

Payable to affiliates on the consolidated statement of financial condition includes net payable to the Parent of \$829,581 and other affiliates of \$130,083. The net payable

to the Parent includes borrowings of \$344,271, net taxes payable of \$452,462 and other payables of \$32,848; payables to the Parent are unsecured, bear interest at prevailing market rates and are payable on demand. Included in other assets on the consolidated statement of financial condition is a net receivable from affiliates of \$22,003.

The Company sells certain of its receivables to an affiliate. For the six months ended May 31, 2005, \$67,044 of receivables were sold to the affiliate without recourse at book value.

## 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

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

Financial instruments owned and financial instruments sold, not yet purchased are recorded at fair value in the consolidated statement of financial condition, and gains and losses are reflected in principal transactions revenues. 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 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 directly 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 may involve a 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.

Purchases and sales of financial instruments are recorded in the accounts on trade date.

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

### 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 dates.

## Office Facilities

Office facilities consist of fixed assets, leasehold improvements and capitalized software. Fixed assets placed into service on or prior to June 30, 2002 are depreciated utilizing accelerated methods. Leasehold improvements placed into service on or prior to June 30, 2002 are amortized utilizing either accelerated or straight-line methods. Fixed assets and leasehold improvements placed in service after June 30, 2002, are depreciated/amortized utilizing the straight-line method. All fixed assets are depreciated over their useful lives of two to seven years, and leasehold improvements are amortized over the lesser of the lease term or useful life. Capitalized software is amortized utilizing the straight-line method over the useful life of three years.

## Asset Management, Distribution and Administration Fees

Asset management, distribution and administration fees consist primarily of revenues earned from asset management services, the distribution of mutual funds, and customers electing a fee-based pricing arrangement and are generally recognized over the relevant contract period, generally quarterly or annually.

## Investment Banking

Investment banking revenues are derived from the Company's distribution of equity, fixed income securities and unit investment trust products underwritten by affiliates. Investment banking revenues are recorded when services for the transaction are substantially completed.

## 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.

## Goodwill

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," the amortization of goodwill and indefinite-lived intangible assets is not permitted. Instead, those assets must be reviewed annually (or more frequently under certain circumstances) for impairment. During the first quarter of fiscal 2005, the Company completed the annual goodwill impairment test, which did not indicate any goodwill impairment and therefore did not have an effect on the Company's consolidated financial condition. At May 31, 2005, goodwill of approximately \$159,283 was included in the Company's consolidated statement of financial condition as a component of other assets.

## Note 3—Securities Financing Transactions

Reverse repurchase agreements and repurchase agreements, principally U.S. government and federal agency securities, are treated as financing transactions and 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 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 treated as financing transactions and are carried at the amounts of cash collateral advanced and received in connection with the transactions.

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financing. Pledged securities that can be resold 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 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:

	<u>May 31, 2005</u>
Financial instruments owned:	
U.S. government and agency securities	\$421,089
Corporate and other debt	<u>620,542</u>
Total	<u>\$1,041,631</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 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 the delivery to counterparties to cover short positions.

At May 31, 2005, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$8,554,480, and the fair value of the portion that has been sold or repledged was \$4,910,115.

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, the Company's collateral policies significantly limit 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 delivered from customers.

## Note 4—Subordinated Liabilities

Subordinated liabilities consist of a Cash Subordination Agreement and a Subordinated Revolving Credit Agreement with the Parent.

The Cash Subordination Agreement is for \$750,000 which bears interest at 4.13% per annum, based on London Inter-bank Offered Rate plus 1.03% and has a maturity date of June 30, 2018. Additionally, there is no balance outstanding under the Company's \$1,000,000 Subordinated Revolving Credit Agreement which has a commitment termination date and maturity date of June 30, 2007 and June 30, 2008, respectively. Interest on this borrowing is payable at rates based upon the federal funds rate or the London Inter-bank Offered Rate.

## Note 5—Commitments and Contingencies

### Leases

The Company has non-cancelable operating leases covering office space and equipment. At May 31, 2005, future minimum rental commitments under such leases (net of subleases, principally on office rentals) were as follows:

May 2006	\$141,051
May 2007	130,706
May 2008	105,961
May 2009	88,551
May 2010	70,165
Thereafter	<u>135,570</u>
Total	<u>\$672,004</u>

Included in the table above are \$37,780 of future minimum rental commitments (net of actual sublease income) related to closed or downsized branch offices and support space for which the present value was included in the restructuring charges taken during the year ended November 30, 2002.

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.

### Other Commitments and Contingencies

The Company had approximately \$6,702 of letters of credit outstanding at May 31, 2005 to satisfy various collateral requirements.

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, 2005, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately \$100,000 and \$350,000, respectively.

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.

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

In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases in which claimants seek substantial or indeterminate damages, the Company cannot predict with certainty what the eventual loss or range of loss related to such matters will be. The Company is contesting liability and/or the amount of damages in each pending matter and believes, based on current knowledge and after consultation with counsel, that the outcome of each matter will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome 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 income for such period.

## Note 6—Trading Activities

The Company's trading activities are primarily generated by customer order flow and such customer activities involve the execution, settlement and financing of various customer securities and commodities transactions.

The Company's securities brokerage activities involve certain market and credit risks. Customer securities activities are transacted on either a cash or margin basis and customer commodity transactions are generally transacted on a margin basis subject to individual exchange regulations. These transactions include the purchase and

sale of securities, the writing of options and the purchase and sale of commodity futures and forward contracts. These activities may expose the Company to off-balance sheet risk from customers that may fail to satisfy their obligations, requiring the Company to purchase or sell financial instruments at prevailing market prices.

The Company's exposure to credit risk associated with these transactions is measured on an individual basis, as well as by groups that share similar attributes. The Company services a diverse group of domestic and foreign corporations, governments, and institutional and individual investors. Credit risk may be impacted by trading market volatility. The Company seeks to control risks associated with its customers' activities by requiring customers to maintain collateral in compliance with internal and regulatory guidelines. The Company monitors required margin levels and established credit limits daily and, pursuant to such guidelines, requires customers to deposit additional collateral, or reduce positions, when necessary.

## Note 7—Employee Benefit and Compensation Plans

### Pension Plans and Postretirement Benefits

Substantially all of the employees of the Company are covered by a non-contributory pension plan that is qualified under Section 401(a) of the Internal Revenue Code (the "Qualified Plan") which is sponsored by an affiliate. The employees of the Company have a distinct benefit structure within this plan. Plan assets are available to pay all benefits of all participants; however, for purposes of financial reporting, assets are allocated to the Company as if the Company maintained a separate plan. An unfunded supplemental plan (the "Supplemental Plan") covers 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.

The Morgan Stanley Financial Advisor Pension Protection Program ("FAPPP") was established as a nonqualified plan to guarantee selected financial advisors that their lump sum benefit on pre-2003 qualified plan accruals will be calculated using the qualified plan's lump sum rate or 4.93%, whichever produces a higher benefit. Any difference between the benefits calculated under the FAPPP and the benefits calculated under the Qualified Plan rate will be paid under the FAPPP from Company assets.

Effective January 1, 2004, pensionable earnings under the Qualified Plan are limited to \$170 (unindexed for inflation).

For the Qualified Plan, the Company's policy is to contribute at least the amounts sufficient to meet minimum



funding requirements under applicable employee benefit and tax regulations. Liabilities for benefits payable under the Supplemental Plan and FAPPP are accrued by the Company and are funded when paid to the beneficiaries.

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

	<u>Qualified Plans</u>	<u>Supplemental Plan</u>	<u>FAPPP Plan</u>
<b>Reconciliation of benefit obligation:</b>			
Benefit obligation at beginning of year	\$956,749	\$3,851	\$2,643
Service cost	48,242	—	—
Interest cost	56,776	224	147
Actuarial (gain) loss	50,744	192	(981)
Benefits paid	(90,582)	(451)	(79)
Plan amendment	315	—	—
Benefit obligation at end of year	<u>\$1,022,244</u>	<u>\$3,816</u>	<u>\$1,730</u>
<b>Reconciliation of the fair value of plan assets:</b>			
Fair value of plan assets at beginning of year	\$913,109	\$ —	\$ —
Actual return on plan assets	98,933	—	—
Employer contributions	52,000	451	79
Benefits paid	<u>(90,582)</u>	<u>(451)</u>	<u>(79)</u>
Fair value of plan assets at end of year	<u>\$973,460</u>	<u>\$ —</u>	<u>\$ —</u>
<b>Funded status:</b>			
Funded status	\$(48,784)	\$(3,816)	\$(1,730)
Unrecognized loss	437,050	807	(4,436)
Unrecognized prior service cost	(18,820)	335	4,476
Amount contributed to plan after measurement date	<u>—</u>	<u>75</u>	<u>—</u>
Prepaid (accrued) benefit cost	<u>\$369,446</u>	<u>\$(2,559)</u>	<u>\$(1,690)</u>

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

The Company uses a measurement date of September 30 for its pension and postretirement plans.

### Assumptions

The following table presents the weighted average assumptions used to determine benefit obligations for the year ended 2004:

	<u>Pension</u>	<u>Postretirement</u>
Discount rate	6.05%	6.05%
Rate of future compensation increases	4.75%	n/a
The following table presents the weighted average assumptions used to determine net periodic benefit costs for the year ended 2004.		
	<u>Pension</u>	<u>Postretirement</u>
Discount rate	6.20%	6.20%
Expected long-term rate of return on plan assets	7.25%	n/a
Rate of future compensation increases	5.00%	n/a

The Company uses the expected long-term rate of return on plan assets to compute the expected return on assets. The Company estimates the expected long-term return by utilizing a portfolio return calculator model (the "Portfolio Model") that produces the expected return for a 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.

## Plan Assets

The weighted average asset allocations for the Company's pension plans at November 30, 2004 and the targeted asset allocation for the year ending 2005 ("fiscal 2005") by asset class are as follows:

	<b>November 30, 2004</b>	<b>Fiscal 2005 Targeted</b>
Equity securities	50%	50%
Fixed income securities	44%	50%
Other—primarily cash	6%	—
Total	100%	100%

## Pension Plan Asset Allocation

The Company's asset allocation targets for its pension plan assets are based on its assessment of business and financial conditions, demographic and actuarial data, funding characteristics and related risk factors. Other relevant factors as well as equity and fixed income market sensitivity analysis also were considered in determining this asset mix. The overall allocation is expected to help protect each plan's funded status while generating sufficiently stable real returns (i.e., net of inflation) to help cover current and future pension obligations.

The equity portion of the asset allocation utilizes a combination of active and passive investment strategies as well as different investment styles, while a portion of the fixed income asset allocation utilizes longer duration fixed income securities to help reduce plan exposure to interest rate variation and to correlate assets with obligations. The longer duration fixed income allocation also is expected to further stabilize plan contributions over the long run. Additionally, potential allocations to other asset classes are intended to provide attractive diversification benefits, absolute return enhancement and/or other potential benefits to the pension plans.

The asset mix of the Company's pension plans is reviewed quarterly by the Morgan Stanley Retirement Plan Investment Committee. When asset class exposure reaches a minimum or maximum level, the plan asset allocation mix is rebalanced back to target allocation levels.

The pension plans' real and actuarial return objectives provide long-term measures for monitoring the investment performance against growth in the pension liabilities. Total pension plan portfolio performance is assessed by comparing actual returns with relevant benchmarks, such as the S&P 500 Index, the Russell 1000 Index and the Lehman Brothers Aggregate Index.

The Company's U.S. pension plans may invest in derivative instruments only to the extent that they comply with all of the pension plans' policy guidelines and are consistent with the pension plans' risk and return objectives. In addition, any investment in derivatives must meet the following conditions:

- Derivatives may be used only to manage risk of the portfolio or if they are deemed to be more attractive than a similar direct investment in the underlying cash market
- Derivatives may not be used in a speculative manner or to leverage the portfolio or for short-term trading
- Derivatives may be used only in the management of the pension plans' 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

## Cash Flows

The Company expects to contribute approximately \$20,215 to its pension and other benefit plans in fiscal 2005 based upon their current funded status and expected asset return assumptions.

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

	<b>Pension</b>	<b>Postretirement</b>
	<b>(dollars in millions)</b>	
Fiscal 2005	\$62,957	\$4,443
Fiscal 2006	63,009	4,425
Fiscal 2007	65,780	4,384
Fiscal 2008	68,496	4,264
Fiscal 2009	69,460	4,234
Fiscal 2010–2014	378,215	20,464

## Compensation Plans

Compensation costs are allocated to the Company by the Parent based upon the relative compensation of Company employees participating in the Parent's equity-based compensation programs.

Employees of the Company are eligible to participate in the Company's 401(k) plan upon meeting certain eligibility requirements. The Company matches a portion of each participant's contribution based upon the Company's performance.



The Company participates in the Parent and Subsidiaries Employee Stock Ownership Plan ("ESOP") covering substantially all employees. Contributions to the ESOP and allocation of ESOP shares to employees are made annually at the discretion of the Parent's Board of Directors.

## Note 8—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 various accruals, including deferred compensation and litigation reserves.

## Note 9—Stockholder's Equity and Regulatory Requirements

At May 31, 2005, the Company had 1,000 shares of preferred stock authorized. No shares of preferred stock have been issued.

Morgan Stanley DW Inc. 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, Inc. ("NYSE"). Under these rules, Morgan Stanley DW Inc. 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, 2005, Morgan Stanley DW Inc.'s Net Capital was \$1,325,652, which exceeded the minimum requirement by \$1,236,337.

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.

## Note 10—Fair Value Information

Substantially all of the Company's assets and liabilities are carried at fair value or contracted amounts which approximate fair value. Assets which are recorded at contracted amounts approximating fair value consist largely of short-term secured receivables, including reverse repurchase agreements, securities borrowed, customer receivables and certain other receivables. Similarly, the Company's short-term liabilities such as bank loans, repurchase agreements, securities loaned, customer payables and certain other payables are recorded at contracted amounts approximating fair value. These instruments generally have variable interest rates and/or short-term maturities, in many cases overnight, and accordingly, their fair values are not materially affected by changes in interest rates.

The carrying amount of subordinated liabilities approximated fair value based upon market rates of interest available to the Company at May 31, 2005.

## Note 11—Insurance Recovery

On September 11, 2001, the U.S experienced terrorist attacks targeted against New York City and Washington, D.C. The attacks in New York resulted in the destruction of the World Trade Center complex, where approximately 3,700 of the Company's employees were located, and the temporary closing of the debt and equity financial markets in the U.S. Through the implementation of its business recovery plans, the Company relocated its displaced employees to other facilities.

In the first quarter of fiscal 2005, the Company settled its claim with its insurance carriers related to the events of September 11, 2001. The Company recorded a pre-tax gain of \$202 million as the insurance recovery was in excess of previously recognized costs related to the terrorist attacks (primarily write-offs of leasehold improvements and destroyed technology and telecommunications equipment in the World Trade Center complex, employee relocation and certain other employee-related expenditures, and other business recovery costs).

Securities and cash held in Morgan Stanley DW Inc. accounts are protected up to their full net equity value by a combination of coverage provided by the Securities Investor Protection Corporation ("SIPC") a nonprofit organization created by an Act of Congress and additional protection purchased from a private insurer by Morgan Stanley DW Inc. (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 DW Inc. and do not protect against losses due to market fluctuations. If you would like more information, ask your Financial Advisor for a detailed brochure.

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