

**MS SECURITIES SERVICES INC.**  
**(SEC I.D. No. 8-26804)**

**STATEMENT OF FINANCIAL CONDITION**  
**AS OF JUNE 30, 2010**  
**(UNAUDITED)**

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**MS SECURITIES SERVICES INC.**  
**STATEMENT OF FINANCIAL CONDITION**  
**June 30, 2010**  
**(Unaudited)**  
**(In thousands of dollars, except share data)**

**ASSETS**

Cash	\$ 129
Cash deposited with clearing organization	614
Financial instruments owned, at fair value - Corporate and other debt	1,101
Securities purchased under agreements to resell	3,862,129
Securities borrowed	64,373,846
Securities received as collateral, at fair value	589,359
Receivables from affiliates	710
Rebates receivable and other assets	<u>35,578</u>
Total assets	<u><u>\$ 68,863,466</u></u>

**LIABILITIES AND STOCKHOLDER'S EQUITY**

Securities loaned	\$ 66,643,547
Obligation to return securities received as collateral, at fair value	589,359
Payables to affiliates	1,023,641
Rebates payable and other liabilities	<u>27,688</u>
Total liabilities	<u>68,284,235</u>
Stockholder's equity:	
Common stock (\$1 par value, 1,000 shares authorized, issued and outstanding)	1
Paid-in capital	245,899
Retained earnings	<u>333,331</u>
Total stockholder's equity	<u>579,231</u>
Total liabilities and stockholder's equity	<u><u>\$ 68,863,466</u></u>

See Notes to Statement of Financial Condition.

**MS SECURITIES SERVICES INC.**  
**NOTES TO STATEMENT OF FINANCIAL CONDITION**  
**June 30, 2010**  
**(Unaudited)**  
**(In thousands of dollars)**

**Note 1 - Introduction and Basis of Presentation**

**The Company**

MS Securities Services Inc. (the “Company”) is a wholly owned subsidiary of Morgan Stanley & Co. Incorporated (the “Parent”), which is a wholly owned subsidiary of Morgan Stanley (the “Ultimate Parent”). The Company is registered with the Securities and Exchange Commission (“SEC”) as a broker-dealer and is primarily engaged in the borrowing and lending of equity securities. In addition, the Company trades state and municipal government securities on a principal basis. The Company is considered a guaranteed subsidiary of the Parent under SEC Rule 15c3-1 (the “Net Capital Rule”) and, accordingly, its excess net capital is used by the Parent in determining the Parent’s compliance with the Net Capital Rule.

**Basis of Financial Information**

The 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, and the outcome of litigation matters and tax matters and other matters that affect the statement of financial condition and related disclosures. The Company believes that the estimates utilized in the preparation of the statement of financial condition are prudent and reasonable. Actual results could differ materially from these estimates.

**Related Party Transactions**

At June 30, 2010, the Company had securities borrowed and securities loaned with affiliates of \$7,612,510 and \$65,509,655, respectively. Rebates receivable and other assets and rebates payable and other liabilities include securities borrowed rebates receivable and securities loaned rebates payable with affiliates of \$33,015 and \$8,473, respectively. Securities purchased under agreements to resell are primarily funds loaned overnight to the Parent on a collateralized basis at prevailing market rates. Payables to affiliates relate primarily to income taxes paid by the Ultimate Parent on behalf of the Company.

**Note 2 - Summary of Significant Accounting Policies**

**Cash**

The Company holds its cash on deposit with a federally insured financial institution.

## **Cash Deposited With Clearing Organization**

Cash deposited with clearing organization represents cash deposited with the Options Clearing Corporation.

## **Financial Instruments and Fair Value**

Financial instruments owned, which consists of state and municipal government obligations, are carried at fair value with changes in fair value recognized in earnings each period. Securities received as collateral and obligation to return securities received as collateral are measured at fair value. A description of the Company's policies regarding fair value measurement and its application to these financial instruments follows.

### *Financial Instruments Measured at Fair Value*

All of the instruments within financial instruments owned are measured at fair value, either through the fair value option election or as required by other accounting guidance. These financial instruments primarily represent the Company's trading activities in state and municipal government obligations. In addition, securities received as collateral and obligation to return securities received as collateral are measured at fair value as required by other accounting guidance.

### *Fair Value Measurement – Definition and Hierarchy*

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

In determining fair value, the Company uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions other market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the observability of inputs as follows:

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

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

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

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

#### *Valuation Techniques*

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

Fair value for many cash and OTC contracts is derived primarily using pricing models. Pricing models take into account the contract terms (including maturity) as well as multiple inputs, including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality and model uncertainty. Adjustments for liquidity risk adjust model derived mid-market levels of Level 2 and Level 3 financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trade activity, broker quotes or other external third-party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions. The Company applies credit-related valuation adjustments to its short-term and long-term borrowings (including structured notes and junior subordinated debentures) for which the fair value option was elected and to OTC derivatives. The Company considers the impact of changes in its own credit spreads based upon observations of the Company's secondary bond market spreads when measuring fair value for short-term and long-term borrowings. For OTC derivatives, the impact of changes in both the Company's and the counterparty's credit standing is considered when measuring fair value. In determining the expected exposure, the Company simulates the distribution of the future exposure to a counterparty, then applies market-based default

probabilities to the future exposure, leveraging external third-party credit default swap (“CDS”) spread data. Where CDS spread data is unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty’s credit rating or CDS spread data that references a comparable counterparty may be utilized. The Company also considers collateral held and legally enforceable master netting agreements that mitigate the Company’s exposure to each counterparty. Adjustments for model uncertainty are taken for positions whose underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible. The Company generally subjects all valuations and models to a review process initially and on a periodic basis thereafter.

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

See Note 3 for a description of valuation techniques applied to the major categories of financial instruments measured at fair value.

### **Income Taxes**

Income tax expense is 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.

### **Employee Benefits**

Employees of the Company participate in compensation and benefit plans of the Ultimate Parent and its affiliates.

## **Note 3 – Fair Value Disclosures**

### **Fair Value Measurements**

A description of the valuation techniques applied to the Company’s major categories of assets and liabilities measured at fair value on a recurring basis follows.

#### *Financial instruments owned*

The fair value of municipal securities is estimated using recently executed transactions, market price quotations and pricing models that factor in, where applicable, interest rates, bond or credit default swap spreads and volatility. Municipal securities are generally categorized in Level 2 of the fair value hierarchy.

#### *Securities received as collateral and obligation to return securities received as collateral*

Securities received as collateral and obligation to return securities received as collateral are generally valued based on quoted market prices and are categorized in Level 1 of the fair value

hierarchy. A portion of the municipal securities, securities received as collateral and obligation to return securities received as collateral are valued using pricing models or based on inputs that are unobservable and are categorized in Level 2 of the fair value hierarchy.

The following fair value hierarchy table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of June 30, 2010:

**Assets and Liabilities Measured at Fair Value on a Recurring Basis as of June 30, 2010**

	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Balance as of June 30, 2010</b>
<b>Assets</b>			
Financial instruments owned:			
Corporate and other debt -			
Municipal securities	\$ -	\$ 1,101	\$ 1,101
Securities received as collateral	556,797	32,562	589,359
<b>Liabilities</b>			
Obligation to return securities received as collateral	\$ 556,797	\$ 32,562	\$ 589,359

**Note 4 – Collateralized Transactions**

Securities borrowed and securities loaned are carried at the amounts of cash collateral advanced and received in connection with the transactions.

The Company enters into securities borrowed and securities loaned transactions to accommodate customers of the Parent. Under securities borrowed transactions, the Company receives collateral in the form of securities, which in many cases can be sold or repledged. The Company uses this collateral to enter into securities lending transactions. At June 30, 2010, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$65,790,735 of which \$65,739,946 had been repledged.

The Company receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and related obligation to return the collateral in the statement of financial condition. At June 30, 2010, \$589,359 was reported as securities received as collateral in the statement of financial condition, all of which had been repledged.

The Company manages credit exposure arising from 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 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.

## **Note 5 – Commitments, Guarantees and Contingencies**

### **Letters of Credit**

The Company has the ability to issue letters of credit to satisfy various collateral requirements; however, none were outstanding at June 30, 2010.

### **Legal**

There are no pending legal actions, including arbitrations, class actions and other litigation, arising in connection with the Company's activities as a securities borrowing and securities lending financial services institution. Legal reserves are established in accordance with guidance for accounting for contingences issued by the FASB. Once established, reserves are adjusted where there is more information available or when an event occurs requiring a change. There are no legal reserves in the statement of financial condition as of June 30, 2010.

## **Note 6 - Risk Management**

### **Trading**

The Company trades in fixed income securities, primarily state government and municipal securities. The counterparties to the Company's fixed income transactions include investment advisors, commercial banks, insurance companies, broker-dealers, investment funds and industrial companies.

### **Risk Management**

The Company's risk management policies and related procedures are integrated with those of the Ultimate 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 Ultimate Parent and its subsidiaries.

Risk is an inherent part of the Company's business and activities. The Company has policies and procedures in place for measuring, monitoring and managing each of the various types of significant risks involved in the activities of its Institutional Securities business and support functions. The Company's ability to properly and effectively identify, assess, monitor and manage each of the various types of risk involved in its activities is critical to its soundness and profitability. The Company's portfolio of business activities helps reduce the impact that volatility in any particular area or related areas may have on its net revenues as a whole. The Company seeks to identify, assess, monitor and manage, in accordance with defined policies and



procedures, the following principal risks involved in the Company's business activities: market, credit, capital and liquidity, operational and compliance and legal risk.

The cornerstone of the Company's risk management philosophy is the execution of risk-adjusted returns through prudent risk-taking that protects the Company's capital base and franchise. The Company's risk management philosophy is based on the following principles: comprehensiveness, independence, accountability, defined risk tolerance and transparency. 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, accountability of the Company's business segments, 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 at both the Company and business segments level. In recognition of the increasingly varied and complex nature of the global 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 Board of Directors (the "Board"); the Audit Committee and the Risk Committee of the Board; the Firm Risk Committee ("FRC"); senior management oversight, including the Chief Executive Officer, the Chief Risk Officer, the Chief Financial Officer, the Chief Legal Officer and the Chief Compliance Officer; the Internal Audit Department; independent risk management functions (including the Market Risk Department, Credit Risk Management, the Corporate Treasury Department and the Operational Risk Department) and Company control groups (including the Human Resources Department, the Legal and Compliance Division, the Tax Department and the Financial Control Group), and various other risk control managers, committees and groups located within and across the Company's business segments.

The Board has oversight for the Company's enterprise risk management framework and is responsible for helping to ensure that the Company's risks are managed in a sound manner. Historically, the Board had authorized the Audit Committee, which is comprised solely of independent directors, to oversee risk management. Effective January 1, 2010, the Board established another standing committee, the Risk Committee, which is comprised solely of non-management directors, to assist the Board in the oversight of (i) the Company's risk governance structure, (ii) the Company's risk management and risk assessment guidelines and policies regarding market, credit and liquidity and funding risk, (iii) the Company's risk tolerance and (iv) the performance of the Chief Risk Officer. The Audit Committee continues to review the major operational, franchise, reputational, legal and compliance risk exposures of the Company and the steps management has taken to monitor and control such exposure. The Risk Committee, Audit Committee and Chief Risk Officer report to the full Board on a regular basis.

The Board has also authorized the FRC, a management committee appointed and chaired by the Chief Executive Officer that includes the most senior officers of the Company, including the

Chief Risk Officer, Chief Legal Officer and Chief Financial Officer, to oversee the Company's global risk management structure. The FRC's responsibilities include oversight of the Company's risk management principles, procedures and limits, and the monitoring of capital levels and material market, credit, liquidity and funding, legal, operational, franchise and regulatory risk matters and other risks, as appropriate, and the steps management has taken to monitor and manage such risks. The FRC reports to the full Board, the Audit Committee and the Risk Committee through the Company's Chief Risk Officer.

The Chief Risk Officer, a member of the FRC who reports to the Chief Executive Officer, oversees compliance with Company risk limits; approves certain excessions of Company risk limits; reviews material market, credit and operational risks; and reviews results of risk management processes with the Board, the Audit Committee and the Risk Committee, as appropriate.

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 examines the Company's operational and control environment and conducts audits designed to cover all major risk categories.

The risk management functions and the Company control groups are independent of the Company's business units, assist senior management and the FRC 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 of the Company's business segments also has designated operations officers, committees and groups to manage and monitor specific risks and report to the business segment risk committee. The Company control groups work with business segment control groups (including the Operations Division and Information Technology Division) to review the risk monitoring and risk management policies and procedures relating to, among other things, the business segment's market, credit and operational risk profile, sales practices, reputation, legal enforceability, and operational and technological risks. Participation by the senior officers of the Company and business segment control groups helps ensure that risk policies and procedures, exceptions to risk limits, new products and business ventures, and transactions with risk elements undergo a thorough review.

The following is a discussion of the Company's risk management policies and procedures for its principal risks (other than capital and liquidity risk). The discussion focuses on the Company's securities activities (primarily its institutional trading activities) and corporate lending and related activities. The Company believes that these activities generate a substantial portion of its principal risks. This discussion and the estimated amounts of the Company's market risk exposure generated by the Company's statistical analyses are forward-looking statements. However, the analyses used to assess such risks are not predictions of future events, and actual results may vary significantly from such analyses due to events in the markets in which the Company operates and certain other factors described below.

## **Market Risk**

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio. Generally, the Company incurs market risk as a result of trading and client facilitation activities, principally within the Institutional Securities business where the substantial majority of the Company's Value-at-Risk ("VaR") for market risk exposures is generated.

Sound market risk management is an integral part of the Company's culture. The various business units and trading desks are responsible for ensuring that market risk exposures are well-managed and prudent. The control groups help ensure that these risks are measured and closely monitored and are made transparent to senior management. The Market Risk Department is responsible for ensuring transparency of material market risks, monitoring compliance with established limits, and escalating risk concentrations to appropriate senior management. To execute these responsibilities, the Market Risk Department monitors the Company's risk against limits on aggregate risk exposures, performs a variety of risk analyses, routinely reports risk summaries, and maintains the Company's VaR system. Limits are designed to control price and market liquidity risk. Market risk is monitored through various measures: statistically (using VaR and related analytical measures); by measures of position sensitivity; and through routine stress testing and scenario analyses conducted by the Market Risk Department in collaboration with the business units. The material risks identified by these processes are summarized in reports produced by the Market Risk Department that are circulated to and discussed with senior management, the Risk Committee and the Board.

## **Credit Risk**

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations. The Company is exposed to "single-name" credit risk exposure through the Institutional Securities business. This type of risk requires credit analysis of specific counterparties, both initially and on an ongoing basis.

The Company has structured its credit risk management framework to reflect that each of its businesses generates unique credit risks, and Credit Risk Management establishes Company-wide practices to evaluate, monitor and control credit risk exposure both within and across business segments. The Credit Limits Framework is one of the primary tools used to evaluate and manage credit risk levels across the Company and is calibrated within the Company's risk tolerance. The Credit Limits Framework includes single-name limits and portfolio concentration limits by country, industry and product type. Credit Risk Management is responsible for ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit, and escalating risk concentrations to appropriate senior management. Credit risk exposure is managed by Credit Risk Management and through various risk committees, whose membership includes Credit Risk Management. Accordingly, Credit Risk Management also works closely with the Market Risk Department to monitor risk exposures, including margin loans, mortgage loans and credit sensitive, higher risk transactions.

## **Note 7 - Income Taxes**

The Company is included in the consolidated federal income tax return filed by the Ultimate 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 Ultimate Parent and certain other subsidiaries of the Ultimate 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 Ultimate Parent, all current and deferred taxes are offset with all other intercompany balances with the Ultimate Parent.

The Company is subject to the income and indirect tax laws of the U.S., its states and municipalities and those of the foreign jurisdictions in which the Company has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. The Company must make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and the expense for indirect taxes and must also make estimates about when in the future certain items affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Company regularly assesses the likelihood of assessments in each of the taxing jurisdictions resulting from current and subsequent years' examinations, and tax reserves are established as appropriate.

### **Income Tax Examinations**

The Company is under continuous examination by the Internal Revenue Service (the "IRS") and other tax authorities in certain countries and states in which the Company has significant business operations. During 2010, the IRS is expected to conclude the field work portion of their examination on issues covering tax years 1999-2005. The Company has established unrecognized tax benefits that the Company believes are adequate in relation to the potential for additional assessments. Once established, the Company adjusts unrecognized tax benefits only when more information is available or when an event occurs necessitating a change. The Company believes that the resolution of tax matters will not have a material effect on the statement of financial condition of the Company.

It is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur within the next twelve months. At this time, however, it is not possible to reasonably estimate the expected change to the total amount of unrecognized tax benefits and the impact on the effective tax rate over the next twelve months.

The following are the major tax jurisdictions in which the Company and its affiliates operate and the earliest tax year subject to examination:

<b><u>Jurisdiction</u></b>	<b><u>Tax Year</u></b>
United States	1999
New York State and City	2002

### **Note 8 - Regulatory Requirements**

The Company is a registered broker-dealer and, accordingly, is subject to the net capital requirements of the SEC and FINRA. Under these rules, the Company has elected to compute its net capital requirement in accordance with the "Alternative Net Capital Requirement," which specifies that net capital shall not be less than 2% of aggregate debit items arising from customer transactions or \$250, whichever is greater. At June 30, 2010, the Company's net capital, as defined under such rules, was \$528,547, which exceeded the minimum requirement by \$528,297.

The Company is exempt from the provisions of Rule 15c3-3 under the Securities Exchange Act of 1934 in that the Company's activities are limited to those set forth in the conditions for exemption appearing in paragraph (k)(2)(ii) of the Rule.

### **Note 9 - Subsequent Events**

The Company evaluates subsequent events through the date on which the statement of financial condition is issued. The Company did not note any subsequent events requiring disclosure or adjustment to the statement of financial condition.

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