

MORGAN STANLEY SMITH BARNEY LLC

**CONSOLIDATED STATEMENT OF FINANCIAL CONDITION
AS OF DECEMBER 31, 2012
AND
INDEPENDENT AUDITORS' REPORT**

INDEPENDENT AUDITORS' REPORT

Morgan Stanley Smith Barney LLC:

We have audited the accompanying consolidated statement of financial condition of Morgan Stanley Smith Barney LLC and subsidiaries (the "Company") as of December 31, 2012, and the related notes (the "financial statement").

Management's Responsibility for the Consolidated Financial Statement

Management is responsible for the preparation and fair presentation of this consolidated financial statement in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the consolidated financial statement that is free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on this consolidated financial statement based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the consolidated financial statement in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statement.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statement referred to above presents fairly, in all material respects, the financial position of Morgan Stanley Smith Barney LLC and subsidiaries as of December 31, 2012, in accordance with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

New York, NY
February 28, 2013

MORGAN STANLEY SMITH BARNEY LLC
CONSOLIDATED STATEMENT OF FINANCIAL CONDITION
December 31, 2012
(In thousands of dollars)

ASSETS		
Cash		\$ 281,474
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements		4,571,601
Financial instruments owned, at fair value (approximately \$432,190 were pledged to various parties):		
U.S. government and agency securities		640,897
Other sovereign government obligations		1,842
Corporate and other debt		1,267,554
Corporate equities		54,447
Derivative contracts		21,416
Investments		297
Physical commodities		3,031
		<hr/>
Total financial instruments owned, at fair value		1,989,484
Securities purchased under agreements to resell		3,321,732
Securities borrowed		398,664
Receivables:		
Customers (net of \$6,372 allowance for doubtful accounts)		13,640,611
Brokers, dealers and clearing organizations		1,263,142
Fees, interest and other		1,092,690
Affiliates		63,730
Premises, equipment and software costs (net of accumulated depreciation of \$26,127)		45,216
Goodwill		4,609,026
Intangible assets (net of accumulated amortization of \$1,010,764)		3,115,230
Other assets		<hr/> 535,115
Total assets	<hr/> \$ 34,927,715	
LIABILITIES AND MEMBER'S EQUITY		
Short-term borrowings - affiliates		\$ 2,166,681
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities		580,316
Other sovereign government obligations		3,718
Corporate and other debt		437,790
Corporate equities		184,698
Derivative contracts		10,823
Physical commodities		<hr/> 157
Total financial instruments sold, not yet purchased, at fair value		1,217,502
Securities sold under agreements to repurchase		4,689,323
Securities loaned		2,738,680
Payables:		
Customers		8,040,494
Brokers, dealers and clearing organizations		187,187
Interest and dividends		29,152
Other liabilities and accrued compensation expenses		<hr/> 4,074,021
Total liabilities		23,143,040
Subordinated liabilities		400,000
Member's equity		<hr/> 11,384,675
Total liabilities and member's equity	<hr/> \$ 34,927,715	

See Notes to Consolidated Statement of Financial Condition.

MORGAN STANLEY SMITH BARNEY LLC
NOTES TO CONSOLIDATED STATEMENT OF FINANCIAL CONDITION
As of December 31, 2012
(In thousands of dollars, except where noted)

Note 1 - Introduction and Basis of Presentation

The Company

Morgan Stanley Smith Barney LLC (“MSSB”) and its subsidiaries (collectively, the “Company”) offer a wide variety of financial products and provide financial services to a large and diversified group of clients, financial institutions and individuals. The Company’s businesses include financial advisory services, sales, and trading in fixed income securities and related products, including foreign exchange and investment activities and new issue distribution of fixed income, equity and packaged products. The Company provides clients with a comprehensive array of financial solutions, including MSSB products and services, and products and services from third party providers, such as insurance companies and mutual fund families. The Company offers brokerage and investment advisory services covering various investment alternatives; financial and wealth planning services; annuity and insurance products; cash management; and retirement plan services through a network of over 16,000 financial advisors in the U.S.

MSSB is registered with the Securities and Exchange Commission (“SEC”) as a broker-dealer and 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 Smith Barney Holdings LLC (the “Parent”). Prior to September 2012, 51% of the Parent was indirectly owned by Morgan Stanley (the “Ultimate Parent”) and 49% by Citigroup Inc. (“Citi”). In September 2012, the Ultimate Parent reached an agreement with Citi to purchase an additional 14% stake in the Parent resulting in a 65% ownership interest. Subject to obtaining the required regulatory approvals, the Ultimate Parent and Citi have reached an agreement with respect to the purchase of Citi’s remaining 35% stake in the Parent, no later than June 1, 2015.

Basis of Financial Information

The consolidated statement of financial condition is prepared in accordance with accounting principles generally accepted in the United States of America (“U.S.”), which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, the valuation of goodwill and intangible assets, compensation, deferred tax assets, the outcome of litigation and tax matters, 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 is prudent and reasonable. Actual results could differ materially from these estimates.

At December 31, 2012, the Company’s consolidated subsidiaries reported \$8,619 of assets, \$6,981 of liabilities and \$1,638 of member’s equity on a stand-alone basis.

All intercompany balances and transactions with the Company’s subsidiaries have been eliminated.

The consolidated statement of financial condition includes the accounts of MSSB and its wholly owned subsidiaries. MSSB’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.

Note 2 - Summary of Significant Accounting Policies

Financial Instruments and Fair Value

A portion of the Company's financial instruments is carried 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 and Financial instruments sold, not yet purchased, are measured at fair value. These financial instruments primarily represent the Company's trading positions and include both cash and derivative products.

The fair value of over-the-counter ("OTC") financial instruments, including derivative contracts related to financial instruments and commodities, is presented in the accompanying consolidated statement of financial condition on a net-by-counterparty basis, when appropriate. Additionally, the Company nets the fair value of cash collateral paid or received against the fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement.

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 relevant 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 one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- Level 3 -- Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

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

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 of the fair value hierarchy (see Note 4). In addition, a downturn in market conditions could lead to declines in the valuation of many instruments.

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

Valuation Techniques

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

Fair value for many cash instruments and OTC derivative contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity) as well as multiple inputs including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, creditworthiness of the counterparty, creditworthiness of the Company, 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. In determining the expected exposure, the Company 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 4 for a description of valuation techniques applied to the major categories of financial instruments measured at fair value.

Valuation Process

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

The Company’s control processes apply to financial instruments categorized in Level 1, Level 2 or Level 3 of the fair value hierarchy, unless otherwise noted. These control processes include:

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

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

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

For financial instruments categorized within Level 3 of the fair value hierarchy, VRG reviews the business unit’s valuation techniques to ensure these are consistent with market participant assumptions.

The results of this independent price verification and any adjustments made by VRG to the fair value generated by the business units are presented to management of the Ultimate Parent and its consolidated subsidiaries, on a regular basis.

Review of New Level 3 Transactions. VRG reviews the models and valuation methodology used to price all new material Level 3 transactions and both FCG and MRD management must approve the fair value of the trade that is initially recognized.

Cash

Cash consists of cash held on deposit.

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

Cash deposited with clearing organizations or segregated under federal and other regulations or requirements include cash 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.

Repurchase and Securities Lending Transactions

Securities borrowed or reverse repurchase agreements and securities loaned or repurchase agreements are treated as collateralized financings. Reverse repurchase agreements and repurchase agreements are carried on the consolidated statement of financial condition at the amounts of cash paid or received, plus accrued interest. Where appropriate, repurchase agreements and reverse repurchase agreements with the same counterparty are reported on a net basis. Securities borrowed and securities loaned are recorded at the amount of cash collateral advanced or received.

Receivables and Payables – Customers

Receivables from customers (net of allowance for doubtful accounts) 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/payables arising from unsettled trades. Payables to brokers, dealers and clearing organizations include amounts payable for securities not received by the Company from a seller by the settlement date and payables to clearing organizations.

Premises, Equipment and Software

Premises and equipment consists of computer and communications equipment, and software. Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are provided by the straight-line method over the estimated useful life of the asset. Estimated useful lives are generally as follows: computer and communications equipment – 3 to 9 years. Estimated useful lives for software costs are generally 3 to 5 years.

Premises, equipment and software costs are tested for impairment whenever events or changes in circumstances suggest that an asset's carrying value may not be fully recoverable in accordance with current accounting guidance.

Goodwill and Intangible Assets

Goodwill is not amortized and is reviewed annually (or more frequently when certain events or circumstances exist) for impairment. Finite lived intangible assets are amortized over their estimated useful lives and reviewed for impairment.

Other Assets

Other assets include, but are not limited to, prepaid expenses. As of December 31, 2012, other assets include \$129,868 of contractual prepayments made on behalf of affiliate and Citi banks in conjunction with its Customer Deposit Sweep Program ("Deposit Program").

Other Liabilities

Other liabilities include, but are not limited to, accrued compensation, deferred income, and accrued expenses.

Accounting Developments

Disclosures about Offsetting Assets and Liabilities. In December 2011, the Financial Accounting Standards Board ("FASB") issued an accounting update that creates new disclosure requirements requiring entities to disclose both gross and net information for derivatives and other financial instruments that are either offset in the statement of financial condition or subject to an enforceable master netting arrangement or similar arrangement.

In January 2013, the FASB issued an accounting update that clarified the intended scope of the new balance sheet offsetting disclosures to derivatives, repurchase agreements, and securities lending transactions to the extent that they are either offset in the statement of financial condition or subject to an enforceable master netting arrangement or similar agreement.

These disclosure requirements are effective for the Company beginning on or after January 1, 2013. Since these amended principles require only additional disclosures concerning offsetting and related arrangements, adoption will not affect the Company's consolidated statement of financial condition.

Note 3- Related Party Transactions

The Company has transactions with the Ultimate Parent and its affiliates. Subordinated liabilities transacted with the Ultimate Parent are described in Note 9.

During 2012, the Company received net assets of \$1,130,000 from the Parent in relation to the contribution of self-clearing assets and liabilities from Citi as a result of the integration of customer accounts, which included \$11,112,823 and \$3,463,504 of customer receivables and payables, respectively. On November 29, 2012, MSSB repaid a portion of its Subordinated liabilities with the Ultimate Parent in the amount of \$250,000. On December 21, 2012, the Company paid a dividend of \$300,000 to the Parent. Morgan Stanley & Co. LLC ("MS&Co.") contributed research services totaling \$18,771 throughout the year.

Assets and receivables from affiliated companies as of December 31, 2012 are comprised of:

Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	\$ 11,500
Reverse repurchase agreements	3,225,800
Securities borrowed	398,664
Receivables - Customers	2,436
Receivables - Brokers, dealers and clearing organizations	979,721
Receivables - Fees, interest and other	500,424
Receivables - Affiliates	63,730
Other assets	1,638

Liabilities and payables to affiliated companies as of December 31, 2012 are comprised of:

Short term borrowings - affiliates	\$ 2,166,681
Repurchase agreements	3,827,102
Securities loaned	1,558,023
Payables - Brokers, dealers and clearing organizations	10,724
Payables - Interest and dividends	1,783
Other liabilities	529
Subordinated liabilities	400,000

Note 4 – Fair Value Disclosures

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 and Financial Instruments Sold, Not Yet Purchased

U.S. Government and Agency Securities

U.S. Treasury Securities

U.S. Treasury securities are valued using quoted market prices. Valuation adjustments are not applied. Accordingly, U.S. Treasury securities are generally categorized in Level 1 of the fair value hierarchy.

U.S. Agency Securities

U.S. agency securities are composed of two main categories consisting of agency-issued debt and agency mortgage pass-through pool securities. Non-callable agency-issued debt securities are generally valued using quoted market prices. Callable agency-issued debt securities are valued by benchmarking model-derived prices to quoted market prices and trade data for identical or comparable securities. The fair value of agency mortgage pass-through pool securities is model-driven based on spreads of the comparable To-be-announced ("TBA") security. Actively traded non-callable agency-issued debt securities are generally categorized in Level 1 of the fair value hierarchy. Callable agency-issued debt securities and agency mortgage pass-through pool securities are generally categorized in Level 2 of the fair value hierarchy.

Other Sovereign Government Obligations

Foreign sovereign government obligations are valued using quoted prices in active markets when available. These bonds are categorized in Level 1 of the fair value hierarchy. If the market is less active or prices are dispersed, these bonds are categorized in Level 2 of the fair value hierarchy.

Corporate and Other Debt

State and Municipal Securities

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

Residential Mortgage-Backed Securities (“RMBS”), Commercial Mortgage-Backed Securities (“CMBS”) and other Asset-Backed Securities (“ABS”)

RMBS, CMBS and other ABS may be valued based on price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analyzing expected credit losses, default and recovery rates. In evaluating the fair value of each security, the Company considers security collateral-specific attributes including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity. In addition, for RMBS borrowers, Fair Isaac Corporation (“FICO”) scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are also used as an additional data point for benchmarking purposes or to price outright index positions.

RMBS, CMBS and other ABS are generally categorized in Level 2 of the fair value hierarchy. If external prices or significant spread inputs are unobservable or if the comparability assessment involves significant subjectivity related to property type differences, cash flows, performance and other inputs, then RMBS, CMBS and other ABS are categorized in Level 3 of the fair value hierarchy.

Corporate Bonds

The fair value of corporate bonds is determined using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads obtained from independent external parties such as vendors and brokers adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data do not reference the issuer, then data that reference a comparable issuer are used. When position-specific external price data are not observable, fair value is determined based on either benchmarking to similar instruments or cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates as significant inputs. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy; in instances where prices, spreads or any of the other aforementioned key inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

Corporate Equities

Exchange-Traded Equity Securities

Exchange-traded equity securities are generally valued based on quoted prices from the exchange. To the extent these securities are actively traded, valuation adjustments are not applied, and they are categorized in Level 1 of the fair value hierarchy; otherwise they are categorized in Level 2 or Level 3 of the fair value hierarchy.

Derivative Contracts

Listed Derivative Contracts

Listed derivatives that are actively traded are valued based on quoted prices from the exchange and are categorized in Level 1 of the fair value hierarchy. Listed derivatives that are not actively traded are valued using the same approaches as those applied to OTC derivatives; they are generally categorized in Level 2 of the fair value hierarchy.

OTC Derivative Contracts

OTC derivative contracts include forward, swap and option contracts related to interest rates, foreign currencies, equity prices or commodity prices.

Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be either observed or modeled using a series of techniques and model inputs from comparable benchmarks, including closed-form analytic formulas, such as the Black-Scholes option-pricing model, and simulation models or a combination thereof. Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swaps, certain option contracts and certain credit default swaps. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. A substantial majority of OTC derivative products valued by the Company using pricing models fall into this category and are categorized in Level 2 of the fair value hierarchy.

For further information on derivative instruments, see Note 10.

Investments

All equity investments purchased in connection with investment activities are recorded at fair value and are included within Financial instruments owned – Investments in the consolidated statement of financial condition. The carrying value of such investments reflects expected exit values based upon appropriate valuation techniques applied on a consistent basis. Such techniques employ various market, income and cost approaches to determine fair value at the measurement date. These investments are categorized in Level 3 of the fair value hierarchy because, due to infrequent trading, exit prices tend to be unobservable and reliance is placed on the above methods.

Physical Commodities

The Company trades various precious metals on behalf of its customers. Fair value for physical commodities is determined using observable inputs, including broker quotations and published indices. Physical commodities are categorized in Level 2 of the fair value hierarchy.

The following fair value hierarchy table presents information about the Company's financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2012. See Note 2 for a discussion of the Company's policies regarding the fair value hierarchy.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2012

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance December 31, 2012
Assets:				
Financial instruments owned:				
U.S. government and agency securities:				
U.S. Treasury securities	\$ 385,932	\$ -	\$ -	\$ 385,932
U.S. agency securities	-	254,855	110	254,965
Total U.S. government and agency securities	385,932	254,855	110	640,897
Other sovereign government obligations	16	1,581	245	1,842
Corporate and other debt:				
State and municipal securities	-	474,675	-	474,675
Residential mortgage-backed securities	-	9,230	50	9,280
Commercial mortgage-backed securities	-	134	69	203
Asset-backed securities	-	86	9	95
Corporate bonds	-	767,624	12,674	780,298
Other debt	-	2,950	53	3,003
Total corporate and other debt	-	1,254,699	12,855	1,267,554
Corporate equities ⁽¹⁾	23,339	30,284	824	54,447
Derivative contracts:				
Interest rate contracts	147	430	-	577
Foreign exchange contracts	-	10,998	-	10,998
Equity contracts	1,704	8,069	68	9,841
Total derivative contracts	1,851	19,497	68	21,416
Investments	-	-	297	297
Physical commodities	-	3,031	-	3,031
Total financial instruments owned	\$ 411,138	\$ 1,563,947	\$ 14,399	\$ 1,989,484
Liabilities:				
Financial instruments sold, not yet purchased:				
U.S. government and agency securities:				
U.S. Treasury securities	\$ 578,997	\$ -	\$ -	\$ 578,997
U.S. agency securities	-	1,319	-	1,319
Total U.S. government and agency securities	578,997	1,319	-	580,316
Other sovereign government obligations	2,244	1,447	27	3,718
Corporate and other debt:				
State and municipal securities	-	8,667	-	8,667
Residential mortgage-backed securities	-	137	-	137
Corporate bonds	-	422,375	4,392	426,767
Other debt	-	2,203	16	2,219
Total corporate and other debt	-	433,382	4,408	437,790
Corporate equities ⁽¹⁾	46,598	138,100	-	184,698
Derivative contracts				
Interest rate contracts	27	-	-	27
Foreign exchange contracts	-	10,794	-	10,794
Equity contracts	-	2	-	2
Total derivative contracts	27	10,796	-	10,823
Physical commodities	-	157	-	157
Total financial instruments sold, not yet purchased	\$ 627,866	\$ 585,201	\$ 4,435	\$ 1,217,502

⁽¹⁾ The Company holds or sells short for trading purposes equity securities issued by entities in diverse industries and of varying size.

Transfers Between Fair Value Hierarchy Levels

For assets and liabilities that were transferred between the fair value hierarchy levels during the period, fair values are ascribed as if the assets or liabilities had been transferred as of the beginning of the period.

Financial instruments owned—U.S. government and agency securities

During 2012, the Company reclassified approximately \$33,890 of U.S. government and agency security assets from Level 1 to Level 2 as transactions in these securities did not occur with sufficient frequency and volume to constitute an active market.

During 2012, the Company reclassified approximately \$1,143 of U.S. agency securities from Level 3 to Level 2. The Company reclassified the U.S. agency securities as external prices for these instruments became observable.

Financial instruments owned—Corporate and other debt

During 2012, the Company reclassified approximately \$3,327 of Corporate and other debt, primarily corporate bonds, from Level 3 to Level 2. The Company reclassified the corporate bonds as external prices for these instruments became observable.

Financial instruments owned—Corporate equities

During 2012, the Company reclassified approximately \$1,284 of Corporate equities from Level 3 to Level 2. These reclassifications were primarily related to corporate equities for which external prices became observable.

Quantitative Information about and Sensitivity of Significant Unobservable Inputs used in Recurring Level 3 Fair Value Measurements at December 31, 2012

The disclosures below provide information on the valuation techniques, significant unobservable inputs and their ranges for each major category of assets and liabilities measured at fair value on a recurring basis with a significant Level 3 balance. The level of aggregation and breadth of products cause the range of inputs to be wide and not evenly distributed across the inventory. Further, the range of unobservable inputs may differ across firms in the financial services industry because of diversity in the types of products included in each firm's inventory. The disclosures below also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs.

	<u>Balance at December 31, 2012</u>	<u>Valuation Technique(s)</u>	<u>Significant Unobservable Input(s)/Sensitivity of the Fair Value to Changes in the Unobservable Inputs</u>	<u>Range ⁽¹⁾</u>
Assets				
Financial instruments owned:				
Corporate and other debt:				
Corporate bonds	\$ 12,674	Comparable pricing ⁽²⁾	Comparable bond price/(A)	10 to 156 points
Liabilities				
Financial instruments sold, not yet purchased:				
Corporate and other debt:				
Corporate bonds	\$ 4,392	Comparable pricing ⁽²⁾	Comparable bond price/(A)	50 to 131 points

⁽¹⁾ The ranges of significant unobservable inputs are represented in points. Points are a percentage of par; for example, 156 points would be 156% of par.

⁽²⁾ Prices for the identical instrument are not available and significant subjectivity may be involved when fair value is determined using pricing data available for comparable instruments.

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

^(A) Significant increase (decrease) in the unobservable input in isolation would result in a significantly higher (lower) fair value measurement.

Financial Instruments Not Measured at Fair Value

The table below presents the carrying value, fair value and fair value hierarchy category of certain financial instruments that are not measured at fair value in the consolidated statement of financial condition. The table below excludes certain financial instruments and all non-financial assets and liabilities such as goodwill and intangible assets.

The carrying value of cash and short-term financial instruments such as reverse repurchase agreements, Securities borrowed, repurchase agreements, Securities loaned, certain receivables and payables arising in the ordinary course of business, and Short-term borrowings approximate fair value because of the relatively short period of time between their origination and expected maturity.

The fair value of Subordinated liabilities is generally determined based on transactional data or third party pricing for identical or comparable instruments, when available. Where position-specific external prices are not observable, fair value is determined based on current interest rates and credit spreads for debt instruments with similar terms and maturity.

Financial Instruments Not Measured At Fair Value at December 31, 2012

	At December 31, 2012		Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	\$ 281,474	\$ 281,474	\$ 281,474	\$ -	\$ -
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	4,571,601	4,571,601	4,571,601	-	-
Reverse repurchase agreements	3,321,732	3,321,732	-	3,321,732	-
Securities borrowed	398,664	398,664	-	398,664	-
Receivables: ⁽¹⁾					
Customers	13,640,611	13,640,611	-	13,640,611	-
Brokers, dealers and clearing organizations	1,263,142	1,263,142	-	1,263,142	-
Fees, interest and other	699,777	699,777	-	699,777	-
Affiliates	63,730	63,730	-	63,730	-
Financial Liabilities:					
Short-term borrowings - affiliates	\$ 2,166,681	\$ 2,166,681	\$ -	\$ 2,166,681	\$ -
Repurchase agreements	4,689,323	4,689,323	-	4,689,323	-
Securities loaned	2,738,680	2,738,680	-	2,738,680	-
Payables: ⁽¹⁾					
Customers	8,040,494	8,040,494	-	8,040,494	-
Brokers, dealers and clearing organizations	187,187	187,187	-	187,187	-
Subordinated liabilities	400,000	402,314	-	402,314	-

⁽¹⁾ Accrued interest, fees and dividend receivables and payables where carrying value approximates fair value have been excluded.

Note 5 - Collateralized Transactions

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Company's inventory positions. The Company's policy is generally to take possession of Securities purchased under agreements to resell and Securities borrowed. 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.

The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company receives collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. 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. Margin loans are extended on a demand basis and are not committed facilities. Factors considered in the review of margin loans are the amount of the loan, the intended

purpose, the degree of leverage being employed in the account, and overall evaluation of the portfolio to ensure proper diversification or, in the case of concentrated positions, appropriate liquidity of the underlying collateral or potential hedging strategies to reduce risk. Additionally, transactions relating to concentrated or restricted positions require a review of any legal impediments to liquidation of the underlying collateral. Underlying collateral for margin loans is reviewed with respect to the liquidity of the proposed collateral positions, valuation of securities, historic trading range, volatility analysis and an evaluation of industry concentrations. 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 delivered from customers. At December 31, 2012, there were approximately \$12,330,287 of customer margin loans outstanding.

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financings. Pledged financial instruments that can be sold or repledged by the secured party are identified as Financial instruments owned (pledged to various parties) in 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 counterparties do not have the right to sell or repledge the collateral as of December 31, 2012 were as follows:

Financial instruments owned:

U.S. government and agency securities	\$ 435,583
Other sovereign government obligations	80
Corporate and other debt	869,186
Corporate equities	103
Total	\$ 1,304,952

The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed and derivative 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 and derivative transactions or for delivery to counterparties to cover short positions. As of December 31, 2012, the fair value of financial instruments received as collateral where the Company is permitted to sell or repledge the securities was \$15,962,262 and the fair value of the portion that had been sold or repledged was \$6,607,993.

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 2% of the Company's total assets at December 31, 2012. In addition, substantially all of the collateral held by the Company for resale agreements or bonds borrowed, which together represented approximately 10% of the Company's total assets at December 31, 2012, 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 underwriting and financing commitments, often involve substantial amounts and significant exposure to individual issuers and businesses, including non-investment grade issuers.

As of December 31, 2012, cash of \$4,571,601 was deposited with clearing organizations or segregated under federal and other regulations or requirements.

Note 6 – Variable Interest Entities and Securitization Activities

The Company is involved with various special purpose entities (“SPEs”) in the normal course of business. In most cases, these entities are deemed to be VIEs.

The Company applies accounting guidance for consolidation of VIEs to certain entities in which equity investors do not have the characteristics of a controlling financial interest. The primary beneficiary of a VIE is the party that both (1) has the power to direct the activities of a VIE that most significantly affect the VIE’s economic performance and (2) has an obligation to absorb losses or the right to receive benefits that in either case could potentially be significant to the VIE. The Company consolidates entities of which it is the primary beneficiary. The Company’s involvement with VIEs arises primarily from interests purchased in connection with client facilitation activities. As of December 31, 2012, there are no consolidated VIE’s.

The Company determines whether it is the primary beneficiary of a VIE upon its initial involvement with the VIE and reassesses whether it is the primary beneficiary on an ongoing basis as long as it has any continuing involvement with the VIE. This determination is based upon an analysis of the design of the VIE, including the VIE’s structure and activities, the power to make significant economic decisions held by the Company and by other parties, and the variable interests owned by the Company and other parties. The Company generally has no power.

Securitization transactions generally involve VIEs. Primarily as a result of its client facilitation activities, the Company owned additional securities issued by securitization SPEs for which the maximum exposure to loss is less than specific thresholds. These additional securities totaled \$48,452 at December 31, 2012. These securities were acquired in connection with client facilitation activities. The Company’s primary risk exposure is to the securities issued by the SPE owned by the Company, with the risk highest on the most subordinate class of beneficial interests. These securities generally are included in Financial instruments owned-Corporate and other debt and are measured at fair value. The Company does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees or similar derivatives. The Company’s maximum exposure to loss generally equals the fair value of the securities owned.

Note 7 – Goodwill and Net Intangible Assets

The Company tests goodwill for impairment on an annual basis and on an interim basis when certain events or circumstances exist. The Company tests for impairment at the reporting unit level. For both the annual and interim tests, the Company has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value is less than its carrying amount. If after assessing the totality of events or circumstances, the Company determines it is more likely than not that the fair value of the reporting unit is greater than its carrying amount, then performing the two-step impairment test is not required. However, if the Company concludes otherwise, then it is required to perform the first step of the two-step impairment test. Goodwill impairment is determined by comparing the estimated fair value of the reporting unit with its respective carrying value. If the estimated fair value exceeds the carrying value, goodwill is not deemed to be impaired. If the estimated fair value is below carrying value, however, further analysis is required to determine the amount of the impairment. Additionally, if the carrying value is zero or a negative value and it is determined that it is more likely than not the goodwill is impaired, further analysis is required. The estimated fair value of the reporting unit is derived based on valuation techniques the Company believes market participants would use for the reporting unit.

The estimated fair values are generally determined utilizing methodologies that incorporate price-to-earnings multiples of certain comparable companies and a discounted cash flow methodology for the reporting unit.

The Company completed its annual goodwill impairment testing at July 1, 2012. The Company's testing did not indicate any goodwill impairment as the Company's goodwill had a fair value that was substantially in excess of its carrying value.

There have been no changes in the carrying amount of the Company's goodwill during 2012.

Intangible assets were transferred to the Company by the Parent related to the assets contributed upon MSSB's formation. At December 31, 2012, net intangible assets were as follows:

Customer relationships	\$ 3,065,365
Research	49,865
Net intangible assets at December 31, 2012	<u>\$ 3,115,230</u>

The estimated useful life of MSSB's customer relationships and research are sixteen years and five years, respectively.

Note 8 - Short-Term Borrowings

Short-term borrowings from affiliates are unsecured, bear interest at prevailing market rates and are payable on demand. Such balances consist primarily of intercompany funding from the Ultimate Parent as well as other intercompany payables which settle in the normal course of business.

Note 9 - Subordinated Liabilities

Subordinated liabilities consist of two Subordinated Revolving Credit Agreements with the Ultimate Parent dated May 29, 2009 and December 29, 2009. The maturity dates and interest rates of each subordinated note as of December 31, 2012 are as follows:

Subordinated Notes	Maturity Date	Interest Rate	Par Value
Subordinated Revolver	July 31, 2016	5.41%	\$ 100,000
Subordinated Revolver	February 28, 2017	3.56%	300,000
			<u><u>\$ 400,000</u></u>

Note 10 - Derivative Instruments

The Company may trade listed futures, forwards, options and other derivatives referencing, among other things, interest rates, currencies, investment grade and non-investment grade corporate credits, loans, bonds, U.S. and other sovereign securities, emerging market bonds and loans, credit indices, asset-backed security indices, property indices, mortgage-related and other asset-backed securities and real estate loan products. The Company uses these instruments to hedge their client facilitation activity.

The Company manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (*e.g.*, futures, forwards, swaps and options). The Company manages the market risk associated with its trading activities on a Company-wide basis and on an individual product basis.

The following table summarizes the fair value of derivative instruments not designated as accounting hedges by type of derivative contract on a gross basis as of December 31, 2012. Fair values of derivative contracts in an asset position are included in Financial instruments owned—Derivative contracts. Fair

values of derivative contracts in a liability position are reflected in Financial instruments sold, not yet purchased—Derivative contracts.

	Assets		Liabilities	
	Fair Value	Notional ⁽¹⁾	Fair Value	Notional ⁽¹⁾
Interest rate contracts	\$ 577	\$ 145,655	\$ 27	\$ 597,500
Foreign exchange contracts	10,998	265,208	10,794	254,215
Equity contracts	9,841	351,763	2	180
Commodity contracts	-	-	-	1,231
Total derivatives	\$ 21,416	\$ 762,626	\$ 10,823	\$ 853,126

⁽¹⁾ Notional amounts include gross notional amounts related to open long and short futures contracts of \$10,000 and \$588,731, respectively. The unsettled fair value on these futures contracts (excluded from the table above) of \$50 and \$462, respectively, is included in Receivables - Brokers, dealers and clearing organizations on the consolidated statement of financial condition.

Note 11 – Commitments, Guarantees and Contingencies

Letters of Credit

The Company has the ability to issue letters of credit outstanding to satisfy various collateral requirements; however, none were outstanding at December 31, 2012.

Premises and Equipment

At December 31, 2012, future minimum rental commitments, net of subleases, principally on office rentals were as follows:

Fiscal Year	Gross Amount	Sublease Income	Net Amount
2013	\$ 271,783	\$ 3,250	\$ 268,533
2014	259,105	2,932	256,173
2015	225,459	2,625	222,834
2016	192,194	2,307	189,887
2017	154,086	535	153,551
Thereafter	416,010	670	415,340
Total	\$ 1,518,637	\$ 12,319	\$ 1,506,318

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.

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.

Guarantees

The table below summarizes certain information regarding the Company's obligation under guarantee arrangements at December 31, 2012:

<u>Type of Guarantee</u>	<u>Maximum Potential Payout/Notional</u>					<u>Carrying Amount (Asset)/Liability</u>	
	<u>Years to Maturity</u>						
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>	<u>Total</u>		
Derivative contracts	\$ 26	\$ -	\$ -	\$ -	\$ 26	\$ -	

The Company has 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 measure (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or non-occurrence 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. The Company's use of guarantees is described below by type of guarantee.

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 foreign currency options, cannot be estimated, as increases in foreign exchange rates in the future could possibly be unlimited. Therefore, 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. In certain situations, collateral may be held by the Company for those contracts that meet the definition of a guarantee. Generally, the Company sets collateral requirements by counterparty so that the collateral covers various transactions and products and is not allocated specifically to individual contracts. Also, the Company may recover amounts related to the underlying asset delivered to the Company under the derivative contract.

The Company records all derivative contracts at fair value. 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 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 10.

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 global diversified financial services institution.

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

The Company contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the consolidated statement of financial condition and the Company can reasonably estimate the amount of that loss, the Company accrues the estimated loss by a charge to income. In many proceedings, however, it is inherently difficult to determine whether any loss is probable or even possible or to estimate the amount of any loss. In addition, even where loss is possible or an exposure to loss exists in excess of the liability already accrued with respect to a previously recognized loss contingency, it is not always possible to reasonably estimate the size of the possible loss or range of loss.

For certain legal proceedings, the Company cannot reasonably estimate such losses, particularly for proceedings that are in their early stages of development or where plaintiffs seek substantial or indeterminate damages. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for any proceeding.

For certain other legal proceedings, the Company can estimate reasonably possible losses, additional losses, ranges of loss or ranges of additional loss in excess of amounts accrued, but does not believe, based on current knowledge and after consultation with counsel, that such losses will have a material adverse effect on the Company's consolidated statement of financial condition as a whole.

Note 12 – Sales and Trading Activities

Sales and Trading

The Company conducts sales, trading, financing and client facilitation activities on securities and futures exchanges and in OTC markets. The Company's trading portfolios are managed with a view toward the risk and profitability of the portfolios. The following is a discussion of risk management and the Company's primary risks: market risk, credit risk and operational risk policies and procedures covering these activities.

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 Risk Management 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. Management believes effective risk management is vital to the success of the Company's business activities. Accordingly, the Company has policies and procedures in place to identify, assess, monitor and manage the significant risks involved in the activities of its 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 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. Five key principles underlie this philosophy: comprehensiveness, independence, accountability, defined risk tolerance and transparency. The fast-paced, complex, and constantly-evolving nature of global financial markets requires that the Company maintain a risk management culture that is incisive, knowledgeable about specialized products and markets, and subject to ongoing review and enhancement. To help ensure the efficacy of risk management which is an essential component of the Company's reputation, senior management requires thorough and frequent communication and the appropriate escalation of risk matters.

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) 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, investing, and client facilitation activities where a substantial majority of the Company's 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. Market risk is monitored through various measures: using statistics; by measures of position sensitivity; and through routine stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors, and through scenario analyses conducted in collaboration with business units.

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 primarily incurs credit risk exposure to institutions and individuals. This risk may arise from a variety of business activities, including, but not limited to, entering into derivative contracts under which counterparties have obligations to make payments to the Company; extending credit to clients; providing funding that is secured by physical or financial collateral whose value may at times be insufficient to cover the loan repayment amount; and posting margin and/or collateral to counterparties. This type of risk requires credit analysis of specific counterparties, both initially and on an ongoing basis. The Company also incurs credit risk through margin and non-purpose loans to individual investors, which are collateralized by securities.

The Ultimate Parent has structured its credit risk management framework to reflect that each of its businesses generates unique credit risks, and establishes practices to evaluate, monitor and control credit risk exposure both within and across business segments. The Company 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. The Company's credit risk exposure is managed by credit professionals and risk committees of the Ultimate Parent that monitor risk exposures, including margin loans and credit sensitive, higher risk transactions. See Note 5 for a discussion of Concentration Risk.

Operational Risk

Operational risk refers to the risk of financial or other loss, or damage to a firm's reputation, resulting from inadequate or failed internal processes, people, systems, or from external events (e.g., fraud, legal and compliance risks or damage to physical assets). The Company may incur operational risk across the full scope of its business activities, including revenue-generating activities (e.g., sales and trading) and control

groups (e.g., information technology and trade processing). As such, the Company may incur operational risk in each of its divisions.

The goal of the operational risk management framework is to establish Company-wide operational risk standards related to risk measurement, monitoring and management. Operational risk policies are designed to reduce the likelihood and/or impact of operational incidents as well as to mitigate legal, regulatory, and reputational risks.

Note 13 – Employee Stock Based Compensation Plans

Eligible employees of the Company participate in several of the Ultimate Parent's stock-based compensation plans. The Ultimate Parent accounts for stock-based compensation in accordance with the accounting guidance for equity-based awards. This accounting guidance requires measurement of compensation cost for stock-based awards at fair value and recognition of compensation cost over the service period, net of estimated forfeitures.

Deferred Restricted Stock Units

The Ultimate Parent has granted deferred stock awards pursuant to several stock-based compensation plans. The plans provide for the deferral of a portion of certain employees' long-term incentive compensation with awards made in the form of restricted common stock or in the right to receive unrestricted shares of common stock in the future. Awards under these plans are generally subject to vesting over time contingent upon continued employment and to restrictions on sale, transfer or assignment until the end of a specified period, generally two to three years from date of grant. All or a portion of an award may be canceled if employment is terminated before the end of the relevant restriction period. All or a portion of a vested award also may be canceled in certain limited situations, including termination for cause during the relevant restriction period. Recipients of deferred stock awards generally have voting rights and receive dividend equivalents. The Ultimate Parent determines the fair value of restricted stock units based on the grant date fair value of its common stock, measured as the volume-weighted average price on the date of grant.

In 2012, the Ultimate Parent granted performance-based stock units ("PSUs") to senior executives. PSUs with non-market performance conditions are valued based on the grant date fair value of the Ultimate Parent's common stock, measured as the volume-weighted average price on the date of grant. PSUs with market-based conditions are valued using a Monte Carlo valuation model. These PSUs will vest and convert to shares of common stock in 2015 only if the Ultimate Parent satisfies predetermined performance and market goals over the three-year performance period that began on January 1, 2012 and ends on December 31, 2014. PSU awards have vesting, restriction and cancellation provisions that are generally similar to those in the Ultimate Parent's other deferred stock awards.

Stock Options

The Ultimate Parent has granted stock option awards pursuant to several stock-based compensation plans. The plans provide for the deferral of a portion of certain key employees' discretionary compensation with awards made in the form of stock options generally having an exercise price not less than the fair value of the Ultimate Parent's common stock on the date of grant. Such stock option awards generally become exercisable over a three-year period and expire seven to 10 years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are generally similar to those in deferred restricted stock units. The fair value of stock options is determined using the Black-Scholes valuation model and the single grant life method. Under the single grant life method, option awards with graded vesting are valued using a single weighted-average expected option life.

Stock Based Compensation

Stock-based compensation costs are charged to the Company by the Ultimate Parent based upon the awards granted to employees in the Company participating in the programs.

Note 14 – Employee Benefit Plans

Pension and Postretirement Benefit Plans

Substantially all employees of the Company participate in employee benefit plans sponsored by the Ultimate Parent. The pension plan provides pension benefits that are based on each employee's years of credited service and compensation levels specified in the plan. The U.S. Qualified Plan was closed to new entrants effective July 1, 2007. Effective January 1, 2011, the U.S. Qualified Plan ceased accrual of benefits. Any benefits earned by participants under the plan at December 31, 2010 were preserved and will be payable in the future based on the plan's provisions.

Certain employees are covered by a postretirement plan sponsored by MS&Co. that provides medical and life insurance for eligible retirees and medical insurance for their dependents.

Morgan Stanley 401(k) Savings Plan

Eligible employees receive 401(k) matching cash contributions that are allocated according to participants' current investment direction. Certain employees with eligible pay less than or equal to \$100 will receive a 401(k) Fixed Contribution equal to 2% of eligible pay. Additionally, certain employees receive a 401(k) Transition Contribution based on prior plan membership.

Note 15 - Income Taxes

Certain subsidiaries of the Company are organized as corporations which are subject to federal, state and local income taxes.

The Company is a single-member limited liability company that is treated as a disregarded entity for U.S. federal income tax purpose. The taxable income of the Company will be reported by its Parent which is treated as a partnership for U.S. federal and most state income tax purposes. The Ultimate Parent and Citi will include their distributive share of taxable income from the Parent in their respective federal, state and local income tax returns.

The Company is subject to the income and indirect tax laws of certain state jurisdictions in which the Company has 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.

As of December 31, 2012, the Company has not accrued any unrecognized tax benefits in the Company's consolidated statement of financial condition.

Note 16 - Regulatory Requirements

MSSB 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 Financial Industry Regulatory Authority (“FINRA”). Under these rules, MSSB is required to maintain minimum Net Capital, as defined under SEC Rule 15c3-1, of not less than the greater of 2% of aggregate debit items arising from customer transactions, plus excess margin collateral on reverse repurchase agreements or the CFTC rule stating the risk based requirement represents the sum of 8% of customer risk maintenance margin requirement and 8% of non-customer risk maintenance margin requirement, as defined. FINRA 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 December 31, 2012, MSSB’s Net Capital was \$2,167,165, which exceeded the minimum requirement by \$2,016,752.

Advances to the Ultimate 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 rule of the SEC.

During 2012, introducing customers that cleared on Citigroup Global Markets Inc. (“CGMI”) transferred to MSSB. During the period in which the customers were clearing through CGMI, the proprietary account of a correspondent (commonly referred to as “PAIB”) were treated as allowable assets for net capital computation purposes. As of December 31, 2012, CGMI PAIB accounts were no longer included in the capital computation.

Note 17 – Subsequent Events

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

A copy of our December 31, 2012, consolidated statement of financial condition filed pursuant to Rule 17a-5 of the Securities Exchange Act of 1934 is available for examination at the New York Office of the Securities and Exchange Commission or at our principle office at 1585 Broadway, New York, N.Y. 10036.

A copy of this Morgan Stanley Smith Barney LLC Consolidated Statement of Financial Condition can be viewed online at the Morgan Stanley website at:

http://www.morganstanley.com/about/ir/shareholder/morganstanley_smithbarney_llc.pdf