

MORGAN STANLEY SMITH BARNEY LLC  
(SEC I.D. No. 8-68191)

**CONSOLIDATED STATEMENT OF FINANCIAL CONDITION  
AS OF JUNE 30, 2009**

**(UNAUDITED)**

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**MORGAN STANLEY SMITH BARNEY LLC**  
**CONSOLIDATED STATEMENT OF FINANCIAL CONDITION**  
**June 30, 2009**  
**(UNAUDITED)**  
**(In thousands of dollars)**

**ASSETS**

Cash and cash equivalents	\$ 756,134
Financial instruments owned, at fair value:	
U.S. government and agency securities	1,112,039
Other sovereign government obligations	3,440
Corporate and other debt	985,932
Corporate equities	19,742
Derivative contracts	6,091
Physical commodities	1,548
Investments	3,436
Receivables:	
Brokers, dealers and clearing organizations	237,505
Fees and other	159,052
Affiliates	2,108
Premises, equipment and software costs, at cost (net of accumulated depreciation and amortization of \$2,631)	3,697
Goodwill	4,647,108
Intangible assets (net of accumulated amortization of \$22,379)	4,103,615
Other assets	<u>43,960</u>
Total assets	<u>\$12,085,407</u>

**LIABILITIES AND MEMBER'S EQUITY**

Financial instruments sold, not yet purchased, at fair value:	
U.S. government and federal agency securities	\$ 761,447
Other sovereign government obligations	2,405
Corporate and other debt	442,757
Corporate equities	18,894
Derivative contracts	6,302
Physical Commodities	10,694
Payables:	
Brokers, dealers and clearing organizations	50
Interest and dividends	529
Affiliates	174,803
Compensation and benefits	843,336
Other liabilities and accrued expenses	<u>413,407</u>
Total Liabilities	<u>2,674,624</u>
Subordinated liabilities	<u>100,000</u>
Member's equity	<u>9,310,783</u>
Total liabilities and member's equity	<u>\$12,085,407</u>

See Notes to Consolidated Statement of Financial Condition .

**MORGAN STANLEY SMITH BARNEY LLC**  
**NOTES TO CONSOLIDATED STATEMENT OF FINANCIAL CONDITION**  
**As of June 30, 2009**  
**(Unaudited)**  
**(In thousands of dollars, except where noted)**

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

**The Company**

Morgan Stanley Smith Barney LLC (“MSSB”) (the “Company”) was formed on February 2, 2009 and provides a wide variety of financial products and 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. The formation of MSSB creates a new global leader in wealth management with over 130 years of experience consisting of over 17,700 financial advisors and 1,000 brokerage locations around the world.

MSSB is registered with the Securities and Exchange Commission (“SEC”) as a introducing broker-dealer and is also registered as a non-clearing futures commission merchant with the Commodity Futures Trading Commission (“CFTC”). It introduces its customer transactions and accounts to Morgan Stanley and Co. Inc. (“MS&Co) and Citigroup Global Markets Inc, (“CGMI”) for clearance and settlement. The Company is a wholly owned subsidiary of Morgan Stanley Smith Barney Holdings LLC (the “Parent”) (“MSSB Holdings LLC”), of which 51% is owned by Morgan Stanley (the “Ultimate Parent”) and 49% by CGMI, an affiliate of Citigroup Inc. (“Citi”).

**Basis of Financial Information**

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

The consolidated statement of financial condition includes the accounts of MSSB and its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. The Company’s policy is to consolidate all entities in which it owns more than 50% of the outstanding voting stock unless it does not control the entity.

All material intercompany balances and transactions have been eliminated.

## **Related Party Transactions**

The Company has transactions with the Ultimate Parent and its affiliates. A subordinated liability transacted with the Parent is described in Note 5. Morgan Stanley and Co. Inc. (MS&Co) is an affiliate and a wholly owned subsidiary of the Ultimate Parent that provides clearing services for the Company.

Assets and receivables from affiliated companies as of June 30, 2009 are comprised of:

Brokers, dealers and clearing organizations	\$28,445
Interest and dividends	147
Fees and other	243,555

Liabilities and payables to affiliated companies as of June 30, 2009 are comprised of:

Brokers, dealers and clearing organizations	\$50
Interest and dividends	529

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

### **Cash and Cash Equivalents**

Cash and cash equivalents consist of cash and highly liquid investments not held for resale with maturities, when purchased, of three months or less. Cash consists of a non-interest earning deposit held at a U.S. bank.

### **Financial Instruments and Fair Value**

All of the Company's financial instruments are carried at fair value with changes in fair value recognized in earnings each period. 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, either through the fair value option election (discussed below) or as required by other accounting pronouncements. These financial instruments primarily represent the Company's trading and investment activities 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 fair value of cash collateral paid or received against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting agreement.

#### *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 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 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 uses 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 continued 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 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 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 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 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. Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in the Company's own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty's credit spreads is considered when measuring the fair value of assets. 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 considers collateral held and legally enforceable master netting agreements that mitigate the Company's exposure to each counterparty. All valuation adjustments are subject to judgment, are applied on a consistent basis and are based upon observable inputs where available. 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 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.

### **Receivables and Payables – Brokers, Dealers and Clearing Organizations**

Receivables from brokers, dealers and clearing organizations primarily represents outstanding balances between the Company and its clearing brokers.

### **Premises, Equipment and Software Costs**

Premises and equipment consists of leasehold improvements, furniture, fixtures, computer and communication equipment, airplanes, and software (externally purchased and developed for internal use). Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of premises and equipment are provided principally by the straight-line method over the estimated useful life of the asset. Estimates of useful lives are generally as follows: furniture and fixtures – 7 years; computer and communication equipment – 3 to 9 years; and airplanes – 20 years. Estimated useful lives for software costs are generally 3 to 5 years. Leasehold improvements are amortized over the lesser of the estimated useful life of the asset or, where applicable, the remaining term of the lease, but generally not exceeding 15 years.

### **Customer Transactions**

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

### **Income Taxes**

For federal and state income tax purposes, the Company is treated as a disregarded entity and its taxable income will be reported by the Ultimate Parent.

### **Goodwill**

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

### **Translation of Foreign Currencies**

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

## Accounting Developments

In December 2007, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Account Standards (“SFAS”) No. 141(R), “Business Combinations” (“SFAS No. 141(R)”). SFAS 141(R) requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose to investors and other users all of the information needed to evaluate and understand the nature and financial effect of the business combination. SFAS No. 141(R) applies to all transactions or other events in which the Company obtains control of one or more businesses, including those sometimes referred to as “true mergers” or “mergers of equals” and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51” (“SFAS No. 160”). SFAS No. 160 requires reporting entities to present noncontrolling (minority) interests as equity (as opposed to as a liability or mezzanine equity) and provides guidance on the accounting for transactions between an entity and noncontrolling interests. SFAS No. 160 applies prospectively for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The presentation and disclosure requirements, however are to be applied retrospectively. The adoption of SFAS No. 160 did not have a material impact on the Company’s consolidated statement of financial condition.

In April 2008, the FASB issued FASB Staff Position (“FSP”) Financial Accounting Standards (“FAS”) 142-3, “Determination of the Useful Life of Intangible Assets” (“FSP FAS 142-3”). FSP FAS 142-3 removes the requirement of SFAS No. 142, “Goodwill and Other Intangible Assets” (“SFAS No. 142”) for an entity to consider, when determining the useful life of an acquired intangible asset, whether the intangible asset can be renewed without substantial cost or material modifications to the existing terms and conditions associated with the intangible asset. FSP FAS 142-3 replaces the previous useful-life assessment criteria with a requirement that an entity shall consider its own experience in renewing similar arrangements. If the entity has no relevant experience, it would consider market participant assumptions regarding renewal. The adoption of FSP FAS 142-3 on January 1, 2009 did not have a material impact on the Company’s consolidated statement of financial condition.

In April 2009, the FASB issued FSP FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (“FSP FAS 157-4”) and FSP FAS 107-1 and APB 28-1, “Interim Disclosures about Fair Value of Financial Instruments” (“FSP FAS 107-1” and “APB 28-1”). FSP FAS 157-4 provides additional application guidance in determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms what SFAS No. 157, “Fair Value Measurements” states is the objective of fair value measurement—to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. The adoption of FSP FAS 157-4 did not have a material impact on the Company’s consolidated statement of financial condition.

In May 2009, the FASB issued SFAS No. 165, “Subsequent Events” (“SFAS No. 165”). The objective of SFAS No. 165 is to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that

date—that is, whether that date represents the date the financial statements were issued or were available to be issued. The Company evaluates subsequent events through the date that the Company's financial statements are issued. The adoption of SFAS No. 165 did not have a material impact on the Company's consolidated statement of financial condition.

In July 2009, the FASB issued SFAS No. 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162" ("SFAS No. 168"). SFAS No. 168 establishes the FASB Accounting Standards Codification ("Codification") to become the source of authoritative U.S. generally accepted accounting principles ("U.S. GAAP") recognized by the FASB to be applied by nongovernmental entities. All existing accounting standard documents are superseded. All other accounting literature not included in the Codification will be considered non-authoritative. The Codification does not change current GAAP. SFAS No. 168 and the Codification are effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company does not expect the adoption to have a material impact on the Company's statement of financial condition. References to authoritative U.S. GAAP literature, however, in the Company's financial statements and notes thereto will be updated to reflect new Codification references.

### **Note 3 – 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 comprised of two main categories consisting of agency issued debt and mortgage pass-throughs. 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. Mortgage pass-throughs include certain To-be-announced ("TBA") securities and mortgage pass-through pools. TBA securities are generally valued using quoted market prices or are benchmarked thereto. Fair value of mortgage pass-through pools are model driven with respect to spreads of the comparable TBA security. Actively traded non-callable agency issued debt securities and TBA securities are categorized in Level 1 of the fair value hierarchy. Callable agency issued debt securities and mortgage pass-through certificates 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. To the extent quoted prices are not available, fair value is determined based on a valuation model that has as inputs interest rate yield curves, cross-currency basis index spreads, and country credit spreads for structures similar to the bond in terms of issuer, maturity and seniority. These bonds are categorized in Levels 1 or 2 of the fair value hierarchy.

## ***Corporate and Other Debt***

### State and Municipal Securities

The fair value of state and 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. These bonds are generally categorized in Level 2 of the fair value hierarchy.

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

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

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

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

### Corporate Bonds

The fair value of corporate bonds is estimated using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data does not reference the issuer, then data that reference a comparable issuer are used. When observable price quotations are not available, fair value is determined based on cash flow models with yield curves, bond or single name credit default swaps spreads and recovery rates based on collateral values 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 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.

## ***Derivatives and Other 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.

### ***Investments***

#### *Investments*

All equity and debt 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 markets, income and cost approaches to determine fair value at the measurement date. These investments are included 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***

#### *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.

#### *Fair Value Measurement – Other*

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

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 June 30, 2009:

	<b>Quoted Prices in Active Markets for Identical Asset s (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>	<b>Counterparty and Cash Collateral Netting</b>	<b>Balance as of June 30, 2009</b>
<b>Assets:</b>					
Financial instruments owned:					
U.S. treasury securities	\$589,342	\$ —	\$ —	\$ —	\$ 589,342
U.S. agency securities	<u>75,332</u>	<u>447,136</u>	<u>229</u>	<u>—</u>	<u>522,697</u>
Total U.S. government and agency securities	664,674	447,136	229	—	1,112,039
Other sovereign government obligations	3,162	166	112	—	3,440
State and municipal securities	—	326,948	63	—	327,011
Residential mortgage-backed securities	—	126,044	984	—	127,028
Commercial mortgage-backed securities	—	341	26	—	367
Asset-backed securities	—	994	49	—	1,043
Corporate Bonds	—	515,342	10,868	—	526,210
Other debt	<u>8</u>	<u>4,157</u>	<u>108</u>	<u>—</u>	<u>4,273</u>
Total corporate and other debt	8	973,826	12,098	—	985,932
Corporate equities(2)	13,131	3,697	2,914	—	19,742
Derivative contracts(1)	4,334	1,608	149	—	6,091
Investments	—	—	3,436	—	3,436
Physical commodities	—	1,548	—	—	1,548
<b>Liabilities:</b>					
Financial instruments sold, not yet purchased					
U.S treasury securities	\$ 739,550	\$ 524	\$ —	\$ —	\$ 740,074
U.S agency securities	<u>10,356</u>	<u>11,017</u>	<u>—</u>	<u>—</u>	<u>21,373</u>
Total U.S. government and agency securities	749,906	11,541	—	—	761,447
Other sovereign government obligations	2,394	—	11	—	2,405
State and municipal securities	—	3,754	—	—	3,754
Residential mortgage-backed securities	—	11	—	—	11
Asset-backed securities	—	46	—	—	46
Corporate Bonds	—	438,408	505	—	438,913
Other debt	—	<u>33</u>	—	—	<u>33</u>
Total corporate and other debt	—	442,252	505	—	442,757
Corporate equities(2)	9,633	9,261	—	—	18,894
Derivative contracts(1)	6,300	—	2	—	6,302
Physical commodities	—	10,694	—	—	10,694

(1) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titles "Counterparty and Cash Collateral Netting." For contracts with the same counterparty netting among positions classified within the same level is included within that level.

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

Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. Additionally, both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category.

## **Financial Instruments Not Measured at Fair Value**

Some of the Company's financial instruments are not measured at fair value on a recurring basis but nevertheless are recorded at amounts that approximate fair value due to their liquid or short-term nature. Such financial assets and financial liabilities include: Cash and cash equivalents, cash deposited with clearing organizations or segregated under federal and other regulations or requirements, Receivables—customers, Receivables—brokers, dealers and clearing organizations, Payables—customers, and Payables—brokers, dealers and clearing organizations.

### **Note 4 – Goodwill and Net Intangible Assets**

Goodwill in the amount of \$4,647,108 was created upon the transfer of businesses from the Parent. 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. Goodwill impairment is determined by comparing the estimated fair value of a reporting unit with its respective book value. If the estimated fair value exceeds the book value, goodwill at the reporting unit level is not deemed to be impaired. If the estimated fair value is below book value, however, further analysis is required to determine the amount of the impairment. The Company completed its annual goodwill impairment testing, as of June 1, 2009 which did not result in any goodwill impairment.

Intangible assets were allocated from the Parent and primarily contributed by CGMI, consisting of customer relationships, trade names, technology, leases and research. At June 30, 2009, net intangible assets were \$4,103,615.

### **Note 5 - Subordinated Liabilities**

Subordinated liabilities consist of one Subordinated Revolving Credit Agreement with the Ultimate Parent dated May 29, 2009. The maturity date, interest rate and fair value of the subordinated note is as follows:

<u>Subordinated Notes</u>	<u>Maturity Date</u>	<u>Interest Rate</u>	<u>Par Value</u>	<u>Fair Value</u>
Subordinated Revolver	July 31, 2016	5.77%	\$ 100,000	\$ 106,491

### **Note 6 - Derivative Instruments and Hedging Activities**

The Company trades, makes markets and takes proprietary positions globally in 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 for trading.

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, on a worldwide trading division level and on an individual product basis.

In connection with its derivative activities, the Company may enter into master netting agreements and collateral arrangements with counterparties. These agreements provide the Company with the ability to offset a counterparty's rights and obligations, request additional collateral when necessary or liquidate the collateral in the event of counterparty default.

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 June 30, 2009. Fair values of derivative contracts in an asset position are included in Financial instruments owned—derivative and other contracts. Fair values of derivative contracts in a liability position are reflected in Financial instruments sold, not yet purchased—derivative and other contracts.

	Assets		Liabilities	
	<u>Fair Value</u>	<u>Notional</u>	<u>Fair Value</u>	<u>Notional</u>
Derivatives not designated as accounting hedges(1):				
Interest rate contracts	\$ 3,629	\$ 4,611,852	\$ 4,851	\$ 3,502,600
Equity contracts	2,462	146,938	1,451	144,953
Commodity	—	—	—	5,913
Total derivatives not designated as accounting hedges	6,091	4,758,790	6,302	3,653,466
Cash collateral netting	—	—	—	—
Counterparty netting	—	—	—	—
Total derivatives	<u>\$ 6,091</u>	<u>\$ 4,758,790</u>	<u>\$ 6,302</u>	<u>\$ 3,653,466</u>

(1) Notional amounts include net notional related to long and short futures contracts of \$4.2 billion and \$2.7 billion, respectively. The variation margin on these futures contracts (excluded from the table above) of \$1.2 million is included in Receivables—Brokers, dealers and clearing organizations on the consolidated statement of financial condition.

### Note 7 – 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 June 30, 2009.

#### **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. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or in financial distress.

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, including, 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. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how such or if such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief, if any, might be. Subject to the foregoing, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of the pending matters will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome of such matters could be material to the Company's operating results and cash flows for a particular future period, depending on, among other things, the level of the Company's revenues, income or cash flows for such period. Legal reserves have been established in accordance with the requirements for accounting for contingencies. Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

## **Note 8 – Risk Management**

### **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.

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 segment 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 Firm Risk Committee, the Chief Risk Officer, the Internal Audit Department, independent control groups and various other risk control managers, committees and groups located within and across business segments.

The Firm Risk Committee, composed of the Company's most senior officers, oversees the Company's risk management structure. The Firm Risk Committee's responsibilities include oversight of the Company's risk management principles, procedures and limits, and the monitoring of material market, credit, liquidity and funding, legal, operational and franchise risks and the steps management has taken to monitor and manage such risks. The Firm Risk Committee is overseen by the Audit Committee of the Board of Directors (the "Audit Committee").

The Chief Risk Officer, a member of the Firm Risk Committee 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; reviews results of risk management processes with the Audit Committee.

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

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

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

Each of the Company's business segments also has designated operations officers, committees and groups, including operations and information technology groups (collectively, "Segment Control Groups" and together with the Company Control Groups, the "Control Groups") to manage and monitor specific risks and report to the business segment risk committee. The Control Groups work together 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 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 funding 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 trading-related market risk within the Global Wealth Management Group.

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. A variety of limits is 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.

### **Credit Risk**

Credit risk refers to the risk of loss arising from borrower or counterparty default when a borrower, counterparty or obligor does not meet its financial obligations. The Company is exposed to two distinct types of credit risk in its businesses. The Company incurs significant, "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 also incurs "individual consumer" credit risk in the Global Wealth Management Group business through margin and non-purpose loans to individual investors, which are collateralized by securities.

The Company has structured its credit risk management framework to reflect that each of these businesses generates unique credit risks that are appropriately managed discretely. The Institutional Credit Department ("Institutional Credit") evaluates and monitors credit risk exposure for the Institutional Securities business. Institutional Credit 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 in the Global Wealth Management Group business segment is managed through various credit risk committees, whose membership includes Institutional Credit. The Global Wealth Management Group Risk Management Department is responsible for monitoring, measuring and analyzing credit risk exposures, including margin loans and credit sensitive, higher risk transactions.

### **Concentration Risk**

The Company is subject to concentration risk by holding large positions in certain types of securities or commitments to purchase securities of a single issuer, including sovereign governments and other entities, issuers located in a particular country or geographic area, public and private issuers involving developing countries, or issuers engaged in a particular industry. Financial instruments owned by the Company include U.S. government and agency securities, which, in the aggregate, represented approximately 9% of the Company's total assets at June 30, 2009. Positions taken and commitments made by the Company, including positions taken and underwritings, often involve substantial amounts and significant exposure to individual issuers and businesses, including non-investment grade issuers. The Company seeks to limit concentration risk through the use of the systems and procedures described in the preceding discussions of risk management, market risk and credit risk.

### **Note 9 - Employee Compensation Plans**

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

#### **Employee Stock-Based Compensation Plans**

Eligible employees of the Company participate in several of the Ultimate Parent's equity-based stock compensation plans. The Ultimate Parent accounts for stock-based compensation in accordance with

Statement of Financial Accounting Standards (“SFAS”) No. 123R, “Share-Based Payment” (“SFAS No. 123R”). SFAS No. 123R revised the fair value-based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarified guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to service periods. SFAS No. 123R requires measurement of compensation cost for equity-based awards at fair value and recognition of compensation cost over the service period, net of estimated forfeitures.

#### ***Deferred Stock Awards***

The Ultimate Parent has made deferred stock awards pursuant to several equity-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 restricted common stock or in the right to receive unrestricted shares of common stock in the future (“restricted stock units”). 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 five 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 that are not subject to vesting. The Ultimate Parent determines fair value of restricted stock units based on the number of units granted and the grant date fair value of its common stock, measured as the volume-weighted average price on the date of grant.

#### ***Stock Option Awards***

The Ultimate Parent has granted stock option awards pursuant to several equity-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 ten 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 stock awards. 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***

Compensation expense for all stock-based payment awards is recognized using the graded vesting attribution method. Equity-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 10 - Employee Benefit Plans**

Substantially all U.S. employees of the Company participate in Employee Benefit Plans sponsored by the Ultimate Parent. The Ultimate Parent’s U.S. defined benefit pension plan was closed to new participants effective July 1, 2007. In lieu of a defined benefit pension plan, eligible employees who were first hired, rehired or transferred to U.S. on or after July 1, 2007 will be eligible to receive a Retirement Contribution into their 401(k) plan. The amount of the Retirement Contribution is included in the Company’s 401(k) cost and will be equal to between 2% and 5% of eligible pay based on years of service as of December 31. Pension benefits are based on each employee’s years of credited service and compensation levels specified in the plan. Certain employees are covered by postretirement plans sponsored by Ultimate Parent that provide medical and life insurance for eligible retirees and dependents. Employees of the

Company are eligible to participate in a 401(k) plan sponsored by the Company or Ultimate Parent upon meeting certain eligibility requirements.

#### **Note 11 - Income Taxes**

For federal and state income tax purposes, the Company is treated as a disregarded entity and its taxable income will be reported by the Ultimate Parent.

The Company is included in the consolidated federal income tax return filed by the Parent. The Company is included in the combined state and local income tax returns with the Parent and certain other subsidiaries of the Parent.

#### **Income Tax Examinations**

The Ultimate Parent is under continuous examination by the Internal Revenue Service (the “IRS”) and other state tax authorities in certain states in which the Ultimate Parent has significant business operations, such as New York. The IRS authorities are scheduled to conclude the fieldwork portion of their respective examinations during 2009. The Ultimate Parent regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years’ examinations. The Ultimate Parent has established unrecognized tax benefits that the Ultimate Parent believes are adequate in relation to the potential for additional assessments. Once established, the Ultimate Parent adjusts unrecognized tax benefits only when more information is available or when an event occurs necessitating a change. The Ultimate Parent believes that the resolution of tax matters will not have a material effect on the consolidated statement of financial condition of the Ultimate Parent.

It is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur within the next twelve months. However, at this time 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 jurisdiction in which the Company and its affiliates operate and the earliest the earliest tax year subject to examination.

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

#### **Note 12 - Regulatory Requirements**

MSSB is a registered introducing broker-dealer and non-clearing 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, the Company is required to maintain minimum Net Capital, as defined under SEC Rule 15c3-1, of \$500. At June 30, 2009, MSSB’s Net Capital was \$89,306 which exceeded the minimum requirement by \$88,806.

Advances to affiliates, dividend payments and other equity withdrawals are subject to certain notification and other provisions of the net capital rules of the SEC.

**Note 13 – Subsequent Event**

The Company has updated its subsequent events disclosure through September 23, 2009, the filing date of this consolidated statement of financial condition. No further disclosures are necessary.

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