

Prime Dealer Services Corp.

# Statement of Financial Condition

November 30, 2005

Audited

Investments and services are offered through Prime Dealer Services Corp.

Prime Dealer Services Corp.

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## Independent Auditors' Report

### **To the Board of Directors of Prime Dealer Services Corp.**

We have audited the accompanying statement of financial condition of Prime Dealer Services Corp. (the "Company") as of November 30, 2005. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing 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 over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such statement of financial condition presents fairly, in all material respects, the financial position of Prime Dealer Services Corp. at November 30, 2005, in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

New York, New York  
January 26, 2006

## Prime Dealer Services Corp.

## Statement of Financial Condition

(Audited)

(In thousands of dollars, except share data)

November 30, 2005

**Assets**

|                                   |                       |
|-----------------------------------|-----------------------|
| Cash                              | \$ 126,739            |
| Securities borrowed               | 70,214,930            |
| Securities received as collateral | 42,955,812            |
| Other assets                      | <u>303</u>            |
| Total assets                      | <u>\$ 113,297,784</u> |

**Liabilities and Stockholder's Equity**

|   |                       |
|---|-----------------------|
| Securities loaned   | \$ 70,216,143         |
| Obligation to return securities received as collateral                        | 42,955,812            |
| Payables to affiliates  | 41,073                |
| Other liabilities   | <u>32</u>             |
| Total liabilities   | <u>113,213,060</u>    |
| Stockholder's equity:   |                       |
| Common stock (\$1 par value, 1,000 shares authorized, issued and outstanding) | 1                     |
| Paid-in capital   | 24,999                |
| Retained earnings   | <u>59,724</u>         |
| Total stockholder's equity  | <u>84,724</u>         |
| Total liabilities and stockholder's equity                                    | <u>\$ 113,297,784</u> |

*See Notes to Statement of Financial Condition.*

Prime Dealer Services Corp.

## Notes to Statement of Financial Condition

(Audited)

(In thousands of dollars)

November 30, 2005

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

Prime Dealer Services Corp. (the "Company") is a wholly owned subsidiary of Morgan Stanley & Co. Incorporated ("MS&Co."), which is a wholly owned subsidiary of Morgan Stanley. The Company is registered with the Securities and Exchange Commission ("SEC") as a broker-dealer and its operations include fully matched securities lending transactions.

**Basis of Financial Information**

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

**Related Party Transactions**

At November 30, 2005, the Company has disclosed on the balance sheet securities borrowed of \$70,214,930, which relates to cash collateral pledged to an affiliate. The Company enters into securities lending transactions with customers of MS&Co. for which MS&Co. provides the Company with fee income.

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

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

**Note 3 -****Securities Lending Transactions**

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

The Company receives collateral in the form of securities in connection with securities borrowed transactions and is permitted to sell or repledge these securities held as collateral to enter into securities lending transactions. At November 30, 2005, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$113,084,604, substantially all of which had been repledged.

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

The Company manages credit exposure arising from securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset counterparty's rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral.

**Note 4 -****Risk Management**

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

The cornerstone of the Entity's risk management philosophy is protection of the Entity's franchise and reputation. Guardianship is based on three key principles: accountability, transparency and independent oversight.

## Prime Dealer Services Corp.

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Given the importance of effective risk management to the Entity's reputation, senior management requires thorough and frequent communication and appropriate escalation of risk matters.

Risk management at the Entity requires independent Entity-level oversight, constant communication, judgment and knowledge of specialized products and markets. The Entity's senior management takes an active role in the identification, assessment and management of various risks of the Entity. In recognition of the increasingly varied and complex nature of the financial services business, the Entity'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 Entity's risks, coupled with this risk management philosophy, informs the Entity's risk governance structure. The Entity's risk governance structure includes the Firm Risk Committee and the Capital Committee, the Chief Risk Officer, the Internal Audit Department, independent control groups and various risk control managers, committees and groups located within the business units.

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

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

The Internal Audit Department provides independent risk and control assessment and reports to the Audit Committee and administratively to the Chief Legal Officer. The Internal

Audit Department periodically examines the Entity's operational and control environment and conducts audits designed to cover all major risk categories.

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

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

In the normal course of business, the Entity enters into transactions whereby various securities are borrowed from/loaned to counterparties in exchange for collateral. Credit risk occurs when the fair value of the underlying securities borrowed falls below the collateral pledged by the Entity or when the fair value of the securities loaned rises above the collateral received by the Entity.

The Entity seeks to limit credit risk (as well as concentrations of credit risk) created in its business through the use of various control policies and procedures. The Entity measures the fair value of the securities borrowed and loaned against the respective collateral amounts on a daily basis and requests additional collateral when deemed necessary.

### **Note 5 - Fair Value of Financial Instruments**

The majority of the Company's assets and liabilities are recorded at fair value or at amounts that approximate fair value. Such assets and liabilities include cash, securities borrowed and securities loaned.

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**Note 6 -  
Income Taxes**

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

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

**Note 7 -  
Regulatory Requirements**

The Company is a registered broker-dealer and, accordingly, is subject to the Net Capital rules of the SEC and the New York Stock Exchange. Under these rules, the Company has elected to compute its net capital requirement in accordance with the "Alternative Net Capital Requirement," which specifies that Net Capital shall not be less than two percent of aggregate debit items arising from customer transactions or \$250, whichever is greater. At November 30, 2005, the Entity's Net Capital, as defined under such rules, was \$84,155, which exceeded the minimum requirement by \$83,905.

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.

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A copy of our November 30, 2005 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 principal office at 1221 Ave. of the Americas, New York, NY 10020

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

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