

Statement of  
Financial Condition

*November 30, 2007*

*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, 2007. 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, 2007, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche, LLP  
New York, New York

January 28, 2008

## Prime Dealer Services Corp.

## Statement of Financial Condition

(In thousands of dollars, except share data)

November 30, 2007

**Assets**

Cash and cash equivalents	\$ 225,746
Cash deposited with clearing organization	150
Securities borrowed	90,543,633
Securities received as collateral	81,500,769
Receivables from affiliates	1,433
Other assets	55
Total assets	<u>\$ 172,271,786</u>

**Liabilities and Stockholders' Equity**

Securities loaned	\$ 90,546,975
Obligation to return securities received as collateral	81,500,769
Payables to affiliates	83,278
Other liabilities	20
Total liabilities	<u>172,131,042</u>
Stockholders' equity:	
Common stock (\$1 par value, 1,000 shares authorized, issued and outstanding)	1
Paid-in capital	24,999
Retained earnings	115,744
Total stockholders' equity	<u>140,744</u>
Total liabilities and stockholders' equity	<u>\$ 172,271,786</u>

*See Notes to Statement of Financial Condition.*

## Prime Dealer Services Corp.

## Notes to Statement of Financial Condition

(In thousands of dollars)

November 30, 2007

**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 “Parent”). The Company is registered with the Securities and Exchange Commission (“SEC”) as a broker-dealer and is primarily engaged in the borrowing and lending of securities.

**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 statement of financial condition and related disclosures. The Company believes that the estimates utilized in the preparation of the statement of financial condition are prudent and reasonable. Actual results could differ materially from these estimates.

**Related Party Transactions**

At November 30, 2007, the Company has securities borrowed and securities received as collateral transactions of \$90,543,633 and \$81,500,769, respectively, all of which relates to collateral pledged to an affiliate. Payables to affiliates relate primarily to income taxes paid by the Parent on behalf of the Company.

**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 Deposited With Clearing Organization**

Represents cash deposited with the Options Clearing Corporation.

**Financial Instruments and Fair Value**

Securities received as collateral and obligation to return securities received as collateral are measured at fair value. A description of the Company’s policies regarding fair value measurement and its application follows.

*Fair Value Measurement — Definition and Hierarchy*

The Company adopted the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurements” (“SFAS No. 157”), effective December 1, 2006. See “Accounting Developments” herein for additional information regarding the Company’s adoption of SFAS No. 157. Under this standard, 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 including market, income and/or cost approaches. SFAS No. 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company’s assumptions about the assumptions 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 reliability 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. Because 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.

Assets and liabilities utilizing Level 1 inputs include exchange-traded equity securities that are actively traded, listed derivatives that are actively traded, and most U.S. Government and agency securities, and certain other sovereign government obligations.

- Level 2 – Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

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Assets and liabilities utilizing Level 2 inputs include exchange-traded equity securities and listed derivatives that are not actively traded; most over-the counter derivatives; restricted stock; corporate and municipal bonds; certain high-yield debt; and certain mortgage-backed securities; asset-backed securities and collateralized debt obligations securities and retained interest in certain securitization transactions.

- Level 3 – Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

Assets and liabilities utilizing Level 3 inputs include investments in certain high-yield debt, distressed debt (i.e., securities of issuers encountering financial difficulties including bankruptcy or insolvency), certain collateralized debt obligations, certain mortgage-backed and asset-backed securities and retained interests in certain securitization transactions.

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

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability 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. The Company uses inputs that are current as of the measurement date, including during periods of market dislocation. In normally active markets, the price transparency for actively quoted instruments may be reduced during periods of market

dislocation. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3.

### Income Taxes

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

### Accounting Developments

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 on December 1, 2007, did not have a material impact on the Company's financial statements.

In September 2006, the FASB issued SFAS No. 157. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measurements. In addition, SFAS No. 157 disallows the use of block discounts for large holdings of unrestricted financial instruments where quoted prices are readily and regularly available in an active market, and nullifies select guidance provided by Emerging Issues Task Force ("EITF") Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," which prohibited the recognition of trading gains or losses at the inception of a derivative contract, unless the fair value of such derivative is obtained from a quoted market price, or other valuation technique that incorporates observable market data. SFAS No. 157 also requires the Company to consider its own credit spreads when measuring the fair value of liabilities, including derivatives. Effective December 1, 2006, the Company elected early adoption of SFAS No. 157. The adoption of SFAS No. 157 did not have a material effect on the Company.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities"

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which provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The Company has adopted SFAS No. 159 but not elected to apply the fair value option to any financial assets and liabilities at November 30, 2007.

### NOTE 3 - Fair Value Disclosures

The Company's assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with SFAS No. 157. See note 2 for a discussion of the Company's policies regarding this hierarchy.

The following fair value hierarchy table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of November 30, 2007.

**Assets and Liabilities Measured at Fair Value on a Recurring Basis as of November 30, 2007**

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance as of November 30, 2007
<b>Assets</b>				
Securities received as collateral	\$67,338,964	\$14,104,482	\$7,323	\$81,450,769
<b>Liabilities</b>				
Obligation to return securities received as collateral	67,338,964	14,104,482	7,323	81,450,769

### Financial Assets and Liabilities Not Measured at Fair Value

Some of the Company's financial assets and liabilities 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 liabilities include: cash and cash equivalents, cash deposited with clearing organization, securities borrowed and securities loaned.

### NOTE 4 - Securities Lending Transactions

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

In other cases, 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, 2007, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$172,044,402, 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) and a corresponding liability, obligation to return securities received as collateral in certain securities lending transactions.

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

### NOTE 5 - 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 "Company" includes the Parent and its subsidiaries.

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The cornerstone of the Company's risk management philosophy is protection of the Company's franchise, reputation and financial standing. 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, 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 of the Company. In recognition of the increasingly varied and complex nature of the 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, forms the Company's risk governance structure. The Company's risk governance structure includes the Firm Risk Committee, the Capital Structure and Strategic Transactions Committee, the Chief Risk Officer, the Internal Audit Department, independent control groups and various risk control managers, committees and groups located within and across the business units.

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 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 Structure and Strategic Transactions Committee (the "Capital Committee") reviews strategic transactions for the Company and significant changes to the Company's capital structure. The Capital Committee's responsibilities include reviewing measures of capital and evaluating capital resources relative to the Company's risk profile and strategy.

The Chief Risk Officer, a member of the Firm Risk Committee, oversees compliance with Company risk limits;

approves certain excessions of Company risk limits; reviews material market and credit 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 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 unit has a risk committee that is responsible for ensuring that the business unit, 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.

In the normal course of business, the Company 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 Company or when the fair value of the securities loaned rises above the collateral received by the Company.

The Company 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 Company 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.



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**NOTE 6 -  
Income Taxes**

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

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

**Income Tax Examinations**

The Company, through its inclusion on the Parent's returns, is under continuous examination by the Internal Revenue Service (the "IRS") and other state tax authorities in states in which the Company has significant business operations, such as New York. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1999–2005. The Parent regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years' examinations. The Parent has established tax reserves that the Parent believes are adequate in relation to the potential for additional assessments. Once established, the Parent adjusts tax reserves only when more information is available or when an event occurs necessitating a change to the reserves. The effects of reserves are reflected in the Company's provision for/benefit from income taxes in the appropriate reporting periods. The Company believes that the resolution of tax matters will not have a material effect on the financial condition of the Company.

**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 Financial Industry Regulatory Authority. 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, 2007, the Company's net capital, as defined

under such rules, was \$103,779, which exceeded the minimum requirement by \$103,529.

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.

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

**NOTE 8 -  
Subsequent Event**

The Company paid a dividend totaling \$50,000 to MS&Co. as of the close of business on January 11, 2008.

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A copy of our November 30, 2007, 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 nonprofit 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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