

MORGAN STANLEY
Form 10-Q
April 09, 2008
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

For the quarterly period ended February 29, 2008

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

Commission File Number 1-11758

(Exact Name of Registrant as Specified in its Charter)

Delaware

1585 Broadway

36-3145972

(212) 761-4000

(State or other jurisdiction of
incorporation or organization)

New York, NY 10036
(Address of principal executive
offices, including zip code)

(I.R.S. Employer Identification No.)

(Registrant's telephone number,
including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ☒

Non-Accelerated Filer ☐

(Do not check if a smaller reporting company)

Accelerated Filer ☐

Smaller reporting company ☐

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of March 31, 2008, there were 1,107,158,003 shares of the Registrant's Common Stock, par value \$.01 per share, outstanding.

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QUARTERLY REPORT ON FORM 10-Q

For the quarter ended February 29, 2008

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AVAILABLE INFORMATION

Morgan Stanley files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the "SEC"). You may read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, NE, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including Morgan Stanley) file electronically with the SEC. Morgan Stanley's electronic SEC filings are available to the public at the SEC's internet site, www.sec.gov.

Morgan Stanley's internet site is www.morganstanley.com. You can access Morgan Stanley's Investor Relations webpage at www.morganstanley.com/about/ir. Morgan Stanley makes available free of charge, on or through our Investor Relations webpage, its proxy statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Morgan Stanley also makes available, through its Investor Relations webpage, via a link to the SEC's internet site, statements of beneficial ownership of Morgan Stanley's equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

Morgan Stanley has a Corporate Governance webpage. You can access information about Morgan Stanley's corporate governance at www.morganstanley.com/about/company/governance. Morgan Stanley posts the following on its Corporate Governance webpage:

Composite Certificate of Incorporation;

Bylaws;

Charters for our Audit Committee, Compensation, Management Development and Succession Committee and Nominating and Governance Committee;

Corporate Governance Policies;

Policy Regarding Communication with the Board of Directors;

Policy Regarding Director Candidates Recommended by Shareholders;

Policy Regarding Corporate Political Contributions;

Policy Regarding Shareholder Rights Plan;

Code of Ethics and Business Conduct; and

Integrity Hotline.

Morgan Stanley's Code of Ethics and Business Conduct applies to all directors, officers and employees, including its Chief Executive Officer, its Chief Financial Officer and its Controller and Principal Accounting Officer. Morgan Stanley will post any amendments to the Code of Ethics

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and Business Conduct and any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, Inc. (NYSE) on its internet site. You can request a copy of these documents, excluding exhibits, at no cost, by contacting Investor Relations, 1585 Broadway, New York, NY 10036 (212-761-4000). The information on Morgan Stanley s internet site is not incorporated by reference into this report.

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Table of Contents**Part I Financial Information.****Item 1. Financial Statements.****MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(dollars in millions, except share data)**

	February 29, 2008	November 30, 2007
	(unaudited)	
Assets		
Cash and cash equivalents	\$ 20,965	\$ 25,598
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements (including securities at fair value of \$27,768 at February 29, 2008 and \$31,354 at November 30, 2007)	60,964	61,608
Financial instruments owned, at fair value (approximately \$158 billion and \$131 billion were pledged to various parties at February 29, 2008 and November 30, 2007, respectively):		
U.S. government and agency securities	41,028	23,887
Other sovereign government obligations	37,290	21,606
Corporate and other debt	160,773	147,724
Corporate equities	89,006	87,377
Derivative contracts	99,474	77,003
Investments	14,821	14,270
Physical commodities	3,445	3,096
 Total financial instruments owned	 445,837	 374,963
Securities received as collateral, at fair value	49,119	82,229
Collateralized agreements:		
Securities purchased under agreements to resell	143,097	126,887
Securities borrowed	243,695	239,994
Receivables:		
Customers	67,793	76,352
Brokers, dealers and clearing organizations	16,219	16,011
Other loans	9,575	11,629
Fees, interest and other	9,223	8,320
Other investments	5,257	4,524
Premises, equipment and software costs, at cost (net of accumulated depreciation of \$3,152 at February 29, 2008 and \$3,449 at November 30, 2007)	4,548	4,372
Goodwill	3,053	3,024
Intangible assets (net of accumulated amortization of \$189 at February 29, 2008 and \$175 at November 30, 2007) (includes \$392 at fair value at February 29, 2008 and \$428 at fair value at November 30, 2007)	1,008	1,047
Other assets	10,543	8,851
 Total assets	 \$ 1,090,896	 \$ 1,045,409

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (Continued)**

(dollars in millions, except share data)

	February 29, 2008	November 30, 2007
	(unaudited)	
Liabilities and Shareholders' Equity		
Commercial paper and other short-term borrowings (includes \$2,750 at fair value at February 29, 2008 and \$3,068 at fair value at November 30, 2007)	\$ 25,952	\$ 34,495
Deposits (includes \$1,444 at fair value at February 29, 2008 and \$3,769 at fair value at November 30, 2007)	35,687	31,179
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities	9,530	8,221
Other sovereign government obligations	21,211	15,627
Corporate and other debt	9,041	7,592
Corporate equities	41,240	30,899
Derivative contracts	89,392	71,604
Physical commodities	697	398
Total financial instruments sold, not yet purchased	171,111	134,341
Obligation to return securities received as collateral, at fair value	49,119	82,229
Collateralized financings:		
Securities sold under agreements to repurchase	160,492	162,840
Securities loaned	86,890	110,423
Other secured financings (includes \$34,821 at fair value at February 29, 2008 and \$27,772 at fair value at November 30, 2007)	40,753	27,772
Payables:		
Customers	249,711	203,453
Brokers, dealers and clearing organizations	13,745	10,454
Interest and dividends	3,095	1,724
Other liabilities and accrued expenses	20,745	24,606
Long-term borrowings (includes \$42,784 at fair value at February 29, 2008 and \$38,392 at fair value at November 30, 2007)	200,316	190,624
	1,057,616	1,014,140
Commitments and contingencies		
Shareholders' equity:		
Preferred stock	1,100	1,100
Common stock, \$0.01 par value;		
Shares authorized: 3,500,000,000 at February 29, 2008 and November 30, 2007;		
Shares issued: 1,211,701,552 at February 29, 2008 and November 30, 2007;		
Shares outstanding: 1,105,301,550 at February 29, 2008 and 1,056,289,659 at November 30, 2007	12	12
Paid-in capital		1,902
Retained earnings	38,852	38,045
Employee stock trust	7,468	5,569
Accumulated other comprehensive loss	(138)	(199)
Common stock held in treasury, at cost, \$0.01 par value;		
106,400,002 shares at February 29, 2008 and 155,411,893 shares at November 30, 2007	(6,546)	(9,591)
Common stock issued to employee trust	(7,468)	(5,569)
Total shareholders' equity	33,280	31,269

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Total liabilities and shareholders' equity	\$ 1,090,896	\$ 1,045,409
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See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(dollars in millions, except share and per share data)

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(unaudited)	
Revenues:		
Investment banking	\$ 1,109	\$ 1,227
Principal transactions:		
Trading	3,390	4,158
Investments	(346)	880
Commissions	1,199	1,005
Asset management, distribution and administration fees	1,550	1,479
Interest and dividends	13,965	14,171
Other	317	272
Total revenues	21,184	23,192
Interest expense	12,862	13,198
Net revenues	8,322	9,994
Non-interest expenses:		
Compensation and benefits	4,071	4,775
Occupancy and equipment	286	260
Brokerage, clearing and exchange fees	444	361
Information processing and communications	305	277
Marketing and business development	183	153
Professional services	379	419
Other	440	293
Total non-interest expenses	6,108	6,538
Income from continuing operations before gains (losses) from unconsolidated investees and income taxes	2,214	3,456
Gains (losses) from unconsolidated investees	2	(26)
Provision for income taxes	665	1,116
Income from continuing operations	1,551	2,314
Discontinued operations:		
Net gain from discontinued operations		564
Provision for income taxes		206
Net gain on discontinued operations		358
Net income	\$ 1,551	\$ 2,672
Preferred stock dividend requirements	\$ 17	\$ 17
Earnings applicable to common shareholders	\$ 1,534	\$ 2,655

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Earnings per basic common share:			
Income from continuing operations	\$	1.50	\$ 2.28
Gain on discontinued operations			0.35
Earnings per basic common share	\$	1.50	\$ 2.63
Earnings per diluted common share:			
Income from continuing operations	\$	1.45	\$ 2.17
Gain on discontinued operations			0.34
Earnings per diluted common share	\$	1.45	\$ 2.51
Average common shares outstanding:			
Basic		1,020,802,234	1,009,186,993
Diluted		1,057,867,487	1,057,912,545

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in millions)

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(unaudited)	
Net income	\$ 1,551	\$ 2,672
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments(1)	55	(102)
Net change in cash flow hedges(2)	4	8
Minimum pension liability adjustment(3)		2
Net amortization of actuarial loss(4)	5	
Net amortization of prior-service credit(5)	(1)	
Comprehensive income	\$ 1,614	\$ 2,580

(1) Amounts are net of provision for (benefit from) income taxes of \$(54) million and \$47 million for the quarters ended February 29, 2008 and February 28, 2007, respectively.

(2) Amounts are net of provision for income taxes of \$2 million and \$4 million for the quarters ended February 29, 2008 and February 28, 2007, respectively.

(3) Amount is net of provision for income taxes of \$1 million for the quarter ended February 28, 2007.

(4) Amount is net of provision for income taxes of \$3 million for the quarter ended February 29, 2008.

(5) Amount is net of (benefit from) income taxes of \$(1) million for the quarter ended February 29, 2008.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in millions)

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 1,551	\$ 2,672
Adjustments to reconcile net income to net cash used for operating activities:		
(Gains) losses from unconsolidated investees	(2)	26
Compensation payable in common stock and options	608	607
Depreciation and amortization	126	204
Provision for consumer loan losses		195
Gain on sale of Quilter Holdings Ltd.		(168)
Changes in assets and liabilities:		
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	837	(6,171)
Financial instruments owned, net of financial instruments sold, not yet purchased	(30,893)	(46,050)
Securities borrowed	(3,701)	22,538
Securities loaned	(23,533)	11,582
Receivables and other assets	7,108	(16,665)
Payables and other liabilities	47,366	(1,987)
Securities purchased under agreements to resell	(16,210)	(17,375)
Securities sold under agreements to repurchase	(2,348)	20,471
Net cash used for operating activities	(19,091)	(30,121)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (payments for) proceeds from:		
Premises, equipment and software costs	(335)	(295)
Business acquisitions, net of cash acquired	(174)	(1,167)
Net principal disbursed on consumer loans		(623)
Sales of consumer loans		1,578
Net cash used for investing activities	(509)	(507)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (payments for) proceeds from:		
Short-term borrowings	(8,543)	4,523
Derivatives financing activities	549	(578)
Other secured financings	12,981	(409)
Deposits	4,508	8,950
Tax benefits associated with stock-based awards	226	110
Net proceeds from:		
Issuance of common stock	241	332
Issuance of long-term borrowings	9,725	21,839
Issuance of junior subordinated debentures related to China Investment Corporation	5,579	
Payments for:		
Repayments of long-term borrowings	(10,330)	(6,484)
Redemption of Capital Units		(66)
Repurchases of common stock		(1,210)

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Cash dividends	(314)	(305)
Net cash provided by financing activities	14,622	26,702
Effect of exchange rate changes on cash and cash equivalents	345	(44)
Net decrease in cash and cash equivalents	(4,633)	(3,970)
Cash and cash equivalents, at beginning of period	25,598	20,606
Cash and cash equivalents, at end of period	\$ 20,965	\$ 16,636

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were \$11,456 million and \$12,899 million for the quarters ended February 29, 2008 and February 28, 2007, respectively.

Cash payments for income taxes were \$60 million and \$938 million for the quarters ended February 29, 2008 and February 28, 2007, respectively.

See Notes to Condensed Consolidated Financial Statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation and Summary of Significant Accounting Policies.

The Company. Morgan Stanley (the Company) is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Global Wealth Management Group and Asset Management.

A summary of the activities of each of the Company's business segments is as follows:

Institutional Securities includes capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; benchmark indices and risk management analytics; research; and investment activities.

Global Wealth Management Group provides brokerage and investment advisory services covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; cash management services; retirement services; and trust and fiduciary services.

Asset Management provides global asset management products and services in equity, fixed income, alternative investments, which includes hedge funds and funds of funds, and merchant banking, which includes real estate, private equity and infrastructure, to institutional and retail clients through proprietary and third-party distribution channels. Asset Management also engages in investment activities.

Discontinued Operations.

Discover. On June 30, 2007, the Company completed the spin-off (the Discover Spin-off) of its business segment Discover Financial Services (DFS). The results of DFS prior to the Discover Spin-off are reported as discontinued operations for all periods presented.

Quilter Holdings Ltd. The results of Quilter Holdings Ltd. (Quilter) are reported as discontinued operations for all periods presented through its sale on February 28, 2007. The results of Quilter were formerly included in the Global Wealth Management Group business segment.

See Note 14 for additional information on discontinued operations.

Basis of Financial Information. The condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, the outcome of litigation and tax matters, incentive-based compensation accruals and other matters that affect the condensed consolidated financial statements and related disclosures. The Company believes that the estimates utilized in the preparation of the condensed consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

All material intercompany balances and transactions have been eliminated.

Consolidation. The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries, other entities in which the Company has a controlling financial interest and certain variable interest entities (VIE).

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

For entities where (1) the total equity investment at risk is sufficient to enable the entity to finance its activities independently and (2) the equity holders bear the economic residual risks of the entity and have the right to make decisions about the entity's activities, the Company consolidates those entities it controls through a majority voting interest or otherwise. For entities that do not meet these criteria, commonly known as variable interest entities, the Company consolidates those entities where the Company is deemed to be the primary beneficiary when it absorbs a majority of the expected losses or a majority of the expected residual returns, or both, of such entities.

Notwithstanding the above, certain securitization vehicles, commonly known as qualifying special purpose entities ("QSPEs"), are generally not consolidated by the Company if they meet certain criteria regarding the types of assets and derivatives they may hold, the types of sales they may engage in and the range of discretion they may exercise in connection with the assets they hold.

For investments in entities in which the Company does not have a controlling financial interest but has significant influence over operating and financial decisions, the Company generally applies the equity method of accounting, except in instances where the Company has elected to fair value certain eligible investments (see Note 2).

Equity and partnership interests held by entities qualifying for accounting purposes as investment companies are carried at fair value.

The Company's U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated ("MS&Co."), Morgan Stanley & Co. International plc ("MSIP"), Morgan Stanley Japan Securities Co., Ltd. ("MSJS") and Morgan Stanley Investment Advisors Inc.

Income Statement Presentation. The Company, through its subsidiaries and affiliates, provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. In connection with the delivery of the various products and services to clients, the Company manages its revenues and related expenses in the aggregate. As such, when assessing the performance of its businesses, the Company considers its principal trading, investment banking, commissions, and interest and dividend income, along with the associated interest expense, as one integrated activity for each of the Company's separate businesses.

The Company's cost infrastructure supporting its businesses varies by activity. In some cases, these costs are directly attributable to one line of business, and, in other cases, such costs relate to multiple businesses. As such, when assessing the performance of its businesses, the Company does not consider these costs separately but rather assesses performance in the aggregate along with the related revenues.

Therefore, the Company's pricing structure considers various items, including the level of expenses incurred directly and indirectly to support the cost infrastructure, the risk it incurs in connection with a transaction, the overall client relationship and the availability in the market for the particular product and/or service. Accordingly, the Company does not manage or capture the costs associated with the products or services sold or its general and administrative costs by revenue line, in total or by product.

Revenue Recognition.

Investment Banking. Underwriting revenues and fees from mergers, acquisitions and advisory assignments are recorded when services for the transactions are determined to be completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of legal, travel and other costs directly

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

associated with the transaction, are deferred and recognized in the same period as the related investment banking transaction revenue. Underwriting revenues are presented net of related expenses. Non-reimbursed expenses associated with advisory transactions are recorded within Non-interest expenses.

Commissions. The Company generates commissions from executing and clearing customer transactions on stock, options and futures markets. Commission revenues are recorded in the accounts on trade date.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees are recognized over the relevant contract period. In certain management fee arrangements, the Company is entitled to receive performance-based fees (also referred to as incentive fees) when the return on assets under management exceeds certain benchmark returns or other performance targets. In such arrangements, performance fee revenue is accrued (or reversed) quarterly based on measuring account/fund performance to date versus the performance benchmark stated in the investment management agreement. Performance-based fees are recorded within Principal transactions' investments revenues or Asset management, distribution and administration fees depending on the nature of the arrangement.

Financial Instruments and Fair Value.

A significant portion of the Company's financial instruments is 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 instruments primarily represent the Company's trading and investment activities and include both cash and derivative products. In addition, Securities received as collateral and Obligation to return securities received as collateral are measured at fair value as required by other accounting pronouncements. Additionally, certain Commercial paper and other short-term borrowings (primarily structured notes), certain Deposits, certain Other secured financings and certain Long-term borrowings (primarily structured notes and certain junior subordinated debentures) are measured at fair value through the fair value option election. Gains and losses on all of these instruments carried at fair value are reflected in Principal transactions' trading revenues or Principal transactions' investments revenues in the condensed consolidated statements of income. Interest income and expense and dividend income are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions. When interest and dividends are included as a component of the instruments' fair value, interest and dividends are included within Principal transactions' trading revenues or Principal transactions' investments revenues. Otherwise, they are included within Interest and dividend income or Interest expense.

Fair Value Option. The Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS No. 159), effective December 1, 2006. SFAS No. 159 provides entities the option to measure certain financial assets and financial liabilities at fair value with changes in fair value recognized in earnings each period. 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 applies the fair value option for certain eligible instruments, including certain loans and loan commitments, certain equity method investments, certain structured notes and certain junior subordinated debentures, certain certificates of deposits and certain Other secured financings.

Fair Value Measurement Definition and Hierarchy. The Company adopted the provisions of SFAS No. 157, "Fair Value Measurements" (SFAS No. 157), effective December 1, 2006. 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.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

In determining fair value, the Company uses various valuation 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. 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. Examples of assets and liabilities utilizing Level 1 inputs are: most U.S. Government securities; certain other sovereign government obligations; and exchange-traded equity securities and listed derivatives that are actively traded.

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. Examples of assets and liabilities utilizing Level 2 inputs are: U.S. agency securities; municipal bonds; corporate bonds; certain corporate loans and loan commitments; certain residential and commercial mortgage-related instruments (including loans, securities and derivatives); most over-the-counter (OTC) derivatives; physical commodities; mortgage servicing rights; deposits; and most structured notes.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Examples of assets and liabilities utilizing Level 3 inputs are: certain corporate loans and loan commitments; certain residential and commercial mortgage-related instruments (including loans, securities and derivatives); real estate and private equity investments; and long-dated or complex OTC derivatives.

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 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 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 2).

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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 the Company and others are willing to pay for an asset. Ask prices represent the lowest price that the Company and others are 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 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, creditworthiness of the counterparty, option volatility and currency rates. In accordance with SFAS No. 157, the impact of the Company's own credit spreads is also considered when measuring the fair value of liabilities, including OTC derivative contracts. Where appropriate, valuation adjustments are made to account for various factors, including bid-ask spreads, credit quality, market liquidity and the unit of account. These adjustments are subject to judgment, are applied on a consistent basis and are based upon observable inputs where available. The Company subjects all valuations and models to a review process on a periodic basis.

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

U.S. Agency Securities. U.S. agency securities include To-be-announced (TBA) securities and mortgage pass-through certificates. TBA securities are generally valued using quoted market prices or are benchmarked thereto. Fair value of mortgage pass-through certificates is determined via a simulation model, which considers different rate scenarios and historical activity to calculate a spread to the comparable TBA security. U.S. agency securities are generally categorized in Level 2 of the fair value hierarchy.

Other Sovereign Government Obligations. The fair value of foreign sovereign government obligations is generally based on quoted prices in active markets. When 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 generally categorized in Levels 1 or 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. The spread data used are for the same maturity as the bond. If the spread data do not reference the issuer, then data that reference a comparable issuer is 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 swap spreads and recovery rates based on collateral values as key inputs. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy; in instances where significant inputs are unobservable, they are categorized in Level 3 of the hierarchy.

Corporate Loans and Loan Commitments. The fair value of corporate loans is estimated using recently executed transactions, market price quotations (where observable) and market observable credit default swap levels along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable. The fair value of contingent corporate loan commitments is estimated by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of these commitments also takes into account certain fee income.

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While certain corporate loans, closed loan commitments and revolving loans are Level 2 instruments, certain other corporate loans and contingent corporate loan commitments are categorized in Level 3 of the fair value hierarchy.

Municipal Bonds. The fair value of municipal bonds 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.

Mortgage Loans. The valuation of mortgage loans depends upon the exit market for the loan. Loans not intended for securitization are valued based on the analysis of the underlying collateral performance, capital structure and market spreads for comparable positions as prices and/or spreads for specific credits tend to be unobservable. Where comparables do not exist, such loans are valued based on origination price and collateral performance (credit events) since origination. These loans are classified in Levels 2 or 3 of the fair value hierarchy.

The Company also holds certain loan products and mortgage products with the intent to securitize them. When structuring of the related securitization is substantially complete, such that the value likely to be realized in a current transaction is consistent with the price that a securitization entity will pay to acquire these products, the Company marks them to the expected securitized value. Factors affecting the value of loan and mortgage products intended to be securitized include, but are not limited to, loan type, underlying property type and geographic location, loan interest rate, loan to value ratios, debt service coverage ratio, updated cumulative loan loss data, prepayment rates, yields, investor demand, any significant market volatility since the last securitization, and credit enhancement. While these valuation factors may be supported by historical and actual external observations, the determination of their value as it relates to specific positions may require significant judgment. These instruments are classified in Levels 2 or 3 of the fair value hierarchy.

Commercial Mortgage-Backed Securities (CMBS) and Asset-Backed Securities (ABS). CMBS and ABS may be valued based on external price/spread data. When position-specific external price data are not observable, the valuation is based on prices of comparable bonds. Valuation levels of ABS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions. Included in this category are certain interest-only securities, which, in the absence of market prices, are valued as a function of observable whole bond prices and cash flow values of principal-only bonds using current market assumptions at the measurement date. CMBS and ABS are categorized in Level 3 if external prices are unobservable; otherwise they are categorized in Level 2 of the fair value hierarchy.

Retained Interests in Securitization Transactions. The Company engages in securitization activities related to various types of loans and bonds. The Company may retain interests in securitized financial assets as one or more tranches of the securitization. To determine fair values, observable inputs are used if available. Observable inputs, however, may not be available for certain retained interests so 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. When there are no significant unobservable inputs, retained interests are categorized in Level 2 of the fair value hierarchy. When unobservable inputs are significant to the fair value measurement, albeit generally supportable by historical and actual benchmark data, retained interests are categorized in Level 3 of the fair value hierarchy.

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.

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

OTC Derivative Contracts. OTC derivative contracts include forward, swap and option contracts related to interest rates, foreign currencies, credit standing of reference entities, equity prices or commodity prices.

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

Other derivative products, typically the newest and most complex products, require more judgment in the implementation of the valuation technique applied due to the complexity of the valuation assumptions and the reduced observability of inputs. This includes derivative interests in certain mortgage-related collateralized debt obligation (CDO) securities, mortgage-related credit default swaps, basket credit default swaps and CDO-squared positions where direct trading activity or quotes are unobservable. These instruments involve significant unobservable inputs and are categorized in Level 3 of the fair value hierarchy.

Derivative interests in mortgage-related CDOs, for which observability of external price data is extremely limited, are valued based on an evaluation of the market for similar positions as indicated by primary and secondary market activity in the cash CDO and synthetic CDO market. Each position is evaluated independently taking into consideration the underlying collateral performance and pricing, behavior of the tranche under various cumulative loss and prepayment scenarios, deal structures (e.g., non-amortizing reference obligations, call features) and liquidity. While these factors may be supported by historical and actual external observations, the determination of their value as it relates to specific positions nevertheless requires significant judgment.

Mortgage-related credit default swaps are valued based on data from comparable credit instruments in the cash market and trades in comparable swaps as benchmarks, as prices and spreads for the specific credits subject to valuation tend to be of limited observability.

For basket credit default swaps and CDO-squared positions, the correlation between reference credits is often a significant input into the pricing model, in addition to several other more observable inputs such as credit spread, interest and recovery rates. As the correlation input is unobservable for each specific swap, it is benchmarked to standardized proxy baskets for which external data are available.

The Company trades various derivative structures with commodity underlyings. Depending on the type of structure, the model inputs generally include interest rate yield curves, commodity underlier spread curves, volatility of the underlying commodities and, in some cases, the correlation between these inputs. The fair value of these products is estimated using executed trades and broker and consensus data to provide values for the aforementioned inputs. Where these inputs are unobservable, relationships to observable commodities and data points, based on historic and/or implied observations, are employed as a technique to estimate the model input values. Commodity derivatives are generally categorized in Level 2 of the fair value hierarchy; in instances where significant inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

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Investments in Private Equity and Real Estate. The Company's investments in private equity and real estate take the form of direct private equity investments and investments in private equity and real estate funds. The transaction price is used as the best estimate of fair value at inception. Thereafter, valuation is based on an assessment of each underlying investment, incorporating valuations that consider the evaluation of financing and sale transactions with third parties, expected cash flows and market-based information, including comparable company transactions, performance multiples and changes in market outlook, among other factors. These nonpublic investments are included in Level 3 of the fair value hierarchy because they trade infrequently, and, therefore, the fair value is unobservable.

Physical Commodities. The Company trades various physical commodities, including crude oil and refined products, metals and agricultural products. 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.

Deposits. The fair value of certificates of deposit is estimated using third-party quotations. These deposits are categorized in Level 2 of the fair value hierarchy.

Structured Notes. The Company issues structured notes that have coupons or repayment terms linked to the performance of debt or equity securities, indices, currencies or commodities. Fair value of structured notes is estimated using valuation models described in this section for the derivative and debt features of the notes. These models incorporate observable inputs referencing identical or comparable securities, including prices that the notes are linked to, interest rate yield curves, option volatility and currency rates. The impact of the Company's own credit spreads also is included based on the Company's observed secondary bond market spreads. Most structured notes 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 and commodities, is presented in the accompanying condensed consolidated statements 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 arrangement.

Hedge Accounting.

The Company applies hedge accounting for hedges involving various derivative financial instruments and non-U.S. dollar-denominated debt used to hedge interest rate, foreign exchange and credit risk arising from assets and liabilities not held at fair value. These derivative financial instruments are included within Financial instruments owned Derivative contracts or Financial instruments sold, not yet purchased Derivative contracts in the condensed consolidated statements of financial condition.

The Company's hedges are designated and qualify for accounting purposes as one of the following types of hedges: hedges of changes in fair value of assets and liabilities due to the risk being hedged (fair value hedges), hedges of the variability of future cash flows from floating rate assets and liabilities due to the risk being hedged (cash flow hedges) and hedges of net investments in foreign operations whose functional currency is different from the reporting currency of the parent company (net investment hedges).

For all hedges where hedge accounting is being applied, effectiveness testing and other procedures to ensure the ongoing validity of the hedges are performed at least monthly. The impact of hedge ineffectiveness on the

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condensed consolidated statements of income, primarily related to fair value hedges, was a gain of \$16 million and \$13 million for the quarters ended February 29, 2008 and February 28, 2007, respectively. The amount excluded from the assessment of hedge effectiveness was immaterial. If a derivative is de-designated as a hedge, it is thereafter accounted for as a financial instrument used for trading.

Fair Value Hedges Interest Rate Risk. In the first quarter of fiscal 2007, the Company began using regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships (*i.e.*, the Company applied the long-haul method of hedge accounting). A hedging relationship is deemed effective if the fair values of the hedging instrument (derivative) and the hedged item (debt liability) change inversely within a range of 80% to 125%.

Previously, the Company's designated fair value hedges consisted primarily of interest rate swaps designated as fair value hedges of changes in the benchmark interest rate of fixed rate borrowings, including both certificates of deposit and senior long-term borrowings. For these hedges, the Company ensured that the terms of the hedging instruments and hedged items matched and that other accounting criteria were met so that the hedges were assumed to have no ineffectiveness (*i.e.*, the Company applied the shortcut method of hedge accounting). The Company also used interest rate swaps as fair value hedges of the benchmark interest rate risk of host contracts of equity-linked notes that contained embedded derivatives. For these hedging relationships, regression analysis was used for the prospective and retrospective assessments of hedge effectiveness.

For qualifying fair value hedges of benchmark interest rates, the changes in the fair value of the derivative and the changes in the fair value of the hedged liability provide offset of one another and, together with any resulting ineffectiveness, are recorded in Interest expense. When a derivative is de-designated as a hedge, any basis adjustment remaining on the hedged liability is amortized to Interest expense over the remaining life of the liability using the effective interest method.

Fair Value Hedges Credit Risk. Until the fourth quarter of 2007, the Company had designated a portion of a credit derivative embedded in a non-recourse structured note liability as a fair value hedge of the credit risk arising from a loan receivable to which the structured note liability was specifically linked. Regression analysis was used to perform prospective and retrospective assessments of hedge effectiveness for this hedge relationship. The changes in the fair value of the derivative and the changes in the fair value of the hedged item provided offset of one another and, together with any resulting ineffectiveness, were recorded in Principal transactions trading revenues. This hedge was terminated in the fourth quarter of 2007 upon derecognition of both the hedging instrument and the hedged item.

Cash Flow Hedges. The Company applies cash flow hedge accounting to interest rate swaps designated as hedges of the variability of future cash flows from floating rate liabilities due to the benchmark interest rate. The Company uses regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships. Changes in fair value of these interest rate swaps are recorded to Net change in cash flow hedges as a component of Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, to the extent they are effective. Amounts recorded to Accumulated other comprehensive income (loss) are then reclassified to Interest expense as interest on the hedged borrowings is recognized. Any ineffective portion of the change in fair value of these instruments is recorded to Interest expense.

Before the sale of the aircraft leasing business in 2006, the Company applied hedge accounting to interest rate swaps used to hedge variable rate long-term borrowings associated with this business. Changes in the fair value of the swaps were recorded in Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, and then reclassified to Interest expense as interest on the hedged borrowings was recognized.

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In connection with the sale of the aircraft leasing business, the Company de-designated the interest rate swaps associated with this business effective August 31, 2005 and no longer accounts for them as cash flow hedges. Amounts in Accumulated other comprehensive income (loss) related to those interest rate swaps continue to be reclassified to Interest expense since the related borrowings remain outstanding.

Net Investment Hedges. The Company utilizes forward foreign exchange contracts and non-U.S. dollar-denominated debt to manage the currency exposure relating to its net investments in non-U.S. dollar functional currency operations. No hedge ineffectiveness is recognized in earnings since the notional amounts of the hedging instruments equal the portion of the investments being hedged, and, where forward contracts are used, the currencies being exchanged are the functional currencies of the parent and investee; where debt instruments are used as hedges, they are denominated in the functional currency of the investee. The gain or loss from revaluing hedges of net investments in foreign operations at the spot rate is deferred and reported within Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects. The forward points on the hedging instruments are recorded in Interest and dividend revenues or expense.

Condensed Consolidated Statements of Cash Flows.

For purposes of these statements, cash and cash equivalents consist of cash and highly liquid investments not held for resale with maturities, when purchased, of three months or less. In connection with business acquisitions, the Company assumed liabilities of \$77 million and \$7,679 million in the first quarter of fiscal 2008 and fiscal 2007, respectively.

Securitization Activities.

The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations and other types of financial assets (see Note 4). Generally, such transfers of financial assets are accounted for as sales when the Company has relinquished control over the transferred assets. The gain or loss on sale of such financial assets depends, in part, on the previous carrying amount of the assets involved in the transfer allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. Transfers that are not accounted for as sales are accounted for as secured borrowings.

Gains (losses) from Unconsolidated Investees.

The Company invests in unconsolidated investees that provide funds to develop low income communities, renewable energy sources and other structured transactions. These structures provide the Company with tax benefits and are not integral to the operations of the Company. The Company accounts for these investments under the equity method with gains and losses from these investments recorded within Gains (losses) from unconsolidated investees and the applicable tax credits and benefits from tax losses recorded within Provision for income taxes.

Accounting Developments.

Accounting for Uncertainty in Income Taxes. In July 2006, the Financial Accounting Standards Board (the "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,

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accounting in interim periods, disclosure and transition. As a result of the adoption of FIN 48 on December 1, 2007, the Company recorded a cumulative effect adjustment of approximately \$92 million as a decrease to the opening balance of Retained earnings as of December 1, 2007 (see Note 12).

Employee Benefit Plans. In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS No. 158). In fiscal 2007, the Company adopted SFAS No. 158's requirement to recognize the overfunded or underfunded status of its defined benefit and postretirement plans as an asset or liability. In the first quarter of fiscal 2008, the Company recorded an after-tax charge of approximately \$13 million (\$21 million pre-tax) to Shareholders' equity upon early adoption of SFAS No. 158's other requirement to use the fiscal year-end date as the measurement date.

Offsetting of Amounts Related to Certain Contracts. In April 2007, the FASB issued FASB Staff Position (FSP) No. FIN 39-1, *Amendment of FASB Interpretation No. 39*, (FSP FIN 39-1). FSP FIN 39-1 amends certain provisions of FIN 39, *Offsetting of Amounts Related to Certain Contracts*, and permits companies to offset fair value amounts recognized for cash collateral receivables or payables against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement. In accordance with the provisions of FSP FIN 39-1, the Company offset cash collateral receivables and payables against net derivative positions as of February 29, 2008. The adoption of FSP FIN 39-1 on December 1, 2007 did not have a material impact on the Company's condensed consolidated financial statements.

Investment Company Accounting. In June 2007, the AICPA issued Statement of Position (SOP) 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (SOP 07-1). SOP 07-1 provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. In February 2008, the FASB issued a final FSP SOP 07-1-1 to delay indefinitely the effective date of SOP 07-1.

Dividends on Share-Based Payment Awards. In June 2007, the Emerging Issues Task Force (EITF) reached consensus on Issue No. 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* (EITF Issue No. 06-11). EITF Issue No. 06-11 requires that the tax benefit related to dividend equivalents paid on restricted stock units that are expected to vest be recorded as an increase to additional paid-in capital. The Company currently accounts for this tax benefit as a reduction to its income tax provision. EITF Issue No. 06-11 is to be applied prospectively for tax benefits on dividends declared in fiscal years beginning after December 15, 2007. The Company is currently evaluating the potential impact of adopting EITF Issue No. 06-11.

Business Combinations. In December 2007, the FASB issued 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."

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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 December 1, 2009.

Noncontrolling Interests. 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 as of December 1, 2009, except for the presentation and disclosure requirements which will be applied retrospectively for all periods presented.

ASF Framework. In December 2007, the American Securitization Forum (ASF) issued the *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans* (the ASF Framework). The overall purpose of the ASF Framework is to provide recommended guidance for servicers to streamline borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts, including refinancings, forbearances, workout plans, loan modifications, deeds-in-lieu and short sales or short payoffs. The ASF Framework is focused on subprime first-lien adjustable rate residential mortgages loans that have an initial fixed rate period of 36 months or less, are included in securitized pools, were originated between January 1, 2005 and July 31, 2007, and have an initial interest rate reset date between January 1, 2008 and July 31, 2010 (subprime ARM loans).

The ASF Framework categorizes the population of subprime ARM loans into three segments. Segment 1 includes current loans, as defined, where the borrower is likely to be able to refinance into an available mortgage product. It is expected that borrowers in this category should refinance their loans, if they are unable or unwilling to meet their reset payment. Segment 2 includes current loans where the borrower is unlikely to be able to refinance and meet specific criteria related to Fair Isaac Corporation (or FICO) scores and expected payment increase due to the initial adjustment of the interest rate. Borrowers in this segment are eligible for a fast track loan modification under which the interest rate will be kept at the existing rate, generally for five years following the upcoming reset. The ASF Framework indicates that for Segment 2 loans, the servicer can presume that the borrower would be unable to pay pursuant to the original terms of the loan after the interest rate reset, and thus, borrower default on the loan is reasonably foreseeable in absence of a modification. Segment 3 includes loans where the borrower is not current or which do not otherwise qualify for Segment 1 or Segment 2. For loans in this category, the servicer will determine the appropriate loss mitigation approach in a manner consistent with the applicable servicing standard in the transaction documents, but without employing the fast track procedures described under Segment 2.

In January 2008, the SEC's Office of Chief Accountant (the OCA) issued a letter (the OCA Letter) addressing accounting issues that may be raised by the ASF Framework. The OCA letter concluded that the SEC would not object to continuing off-balance sheet accounting treatment for QSPEs that hold Segment 2 subprime ARM loans modified pursuant to the ASF Framework.

For those current loans that are accounted for off-balance sheet that are modified, but not as part of the ASF Framework above, the servicer must perform on an individual basis an analysis of the borrower and the loan to provide sufficient evidence to demonstrate that default on the loan is imminent or reasonably foreseeable.

The Company adopted the ASF Framework during the first quarter of fiscal 2008, but has not yet modified a significant volume of loans using the ASF Framework. The Company does not expect that its application of the

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ASF Framework will impact the off-balance sheet status of Company-sponsored QSPEs that hold Segment 2 subprime ARM loans and is currently evaluating the potential impact on its condensed consolidated statements of income. The total amount of assets owned by Company-sponsored QSPEs that hold subprime ARM loans (including those loans that are not serviced by the Company) as of February 29, 2008, was approximately \$30.5 billion. Of this amount, approximately \$11.8 billion relates to subprime ARM loans serviced by the Company. The Company's retained interests in Company sponsored QSPEs that hold subprime ARM loans totaled approximately \$272 million as of February 29, 2008.

Transfers of Financial Assets and Repurchase Financing Transactions. In February 2008, the FASB issued FSP FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FSP SFAS No. 140-3). The objective of FSP FAS 140-3 is to provide implementation guidance on accounting for a transfer of a financial asset and repurchase financing. Under the guidance in FSP FAS 140-3, there is a presumption that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (*i.e.*, a linked transaction) for purposes of evaluation under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (SFAS No. 140). If certain criteria are met, however, the initial transfer and repurchase financing shall not be evaluated as a linked transaction and shall be evaluated separately under SFAS No. 140. FSP FAS 140-3 is effective for the Company on December 1, 2008. The Company is currently evaluating the potential impact of adopting FSP FAS 140-3.

Disclosures about Derivative Instruments and Hedging Activities. In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161). SFAS No. 161 amends and expands the disclosure requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and requires entities to provide enhanced qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair values and amounts of gains and losses on derivative contracts, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 will be effective for the Company's fiscal 2009 interim and annual consolidated financial statements.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****2. Fair Value Disclosures.*****Fair Value Measurements.***

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 1 for a discussion of the Company's policies regarding this hierarchy.

The following fair value hierarchy tables present information about the Company's assets and liabilities measured at fair value on a recurring basis as of February 29, 2008 and November 30, 2007:

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of February 29, 2008

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance as of February 29, 2008
Assets					
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	\$ 27,768	\$	\$	\$	\$ 27,768
Financial instruments owned:					
U.S. government and agency securities	8,916	31,531	581		41,028
Other sovereign government obligations	30,116	7,159	15		37,290
Corporate and other debt	84	129,067	31,622		160,773
Corporate equities	84,801	2,248	1,957		89,006
Derivative contracts(1)	3,319	120,911	31,910	(56,666)	99,474
Investments	927	1,824	12,070		14,821
Physical commodities		3,445			3,445
Total financial instruments owned	128,163	296,185	78,155	(56,666)	445,837
Securities received as collateral	41,631	7,475	13		49,119
Intangible assets(2)		392			392
Liabilities					
Commercial paper and other short-term borrowings	\$	\$ 2,750	\$	\$	\$ 2,750
Deposits		1,444			1,444
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	8,318	1,212			9,530
Other sovereign government obligations	12,940	8,271			21,211
Corporate and other debt	3	8,434	604		9,041
Corporate equities	40,215	473	552		41,240
Derivative contracts(1)	7,600	110,107	16,069	(44,384)	89,392
Physical commodities		697			697
Total financial instruments sold, not yet purchased	69,076	129,194	17,225	(44,384)	171,111

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Obligation to return securities received as collateral	41,631	7,475	13	49,119
Other secured financings		33,205	1,616	34,821
Long-term borrowings		36,820	5,964	42,784

- (1) Amount represents the impact of counterparty netting across the levels of the fair value hierarchy. Netting among positions classified within the same level is included within that level.
- (2) Amount represents MSRs accounted for at fair value (see Note 4).

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****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) (dollars in millions)	Counterparty and Cash Collateral Netting	Balance as of November 30, 2007
Assets					
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	\$ 31,354	\$	\$	\$	\$ 31,354
Financial instruments owned:					
U.S. government and agency securities	11,038	12,189	660		23,887
Other sovereign government obligations	15,834	5,743	29		21,606
Corporate and other debt	223	110,443	37,058		147,724
Corporate equities	82,592	3,549	1,236		87,377
Derivative contracts(1)	4,526	90,654	21,601	(39,778)	77,003
Investments	953	249	13,068		14,270
Physical commodities		3,096			3,096
Total financial instruments owned	115,166	225,923	73,652	(39,778)	374,963
Securities received as collateral	68,031	14,191	7		82,229
Intangible assets(2)		428			428
Liabilities					
Commercial paper and other short-term borrowings	\$	\$ 3,068	\$	\$	\$ 3,068
Deposits		3,769			3,769
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	8,208	13			8,221
Other sovereign government obligations	9,633	5,994			15,627
Corporate and other debt	16	6,454	1,122		7,592
Corporate equities	29,948	935	16		30,899
Derivative contracts(1)	7,031	86,968	15,663	(38,058)	71,604
Physical commodities		398			398
Total financial instruments sold, not yet purchased	54,836	100,762	16,801	(38,058)	134,341
Obligation to return securities received as collateral	68,031	14,191	7		82,229
Other secured financings		25,451	2,321		27,772
Long-term borrowings		37,994	398		38,392

(1) Amounts represent the impact of counterparty netting across the levels of the fair value hierarchy. Netting among positions classified within the same level is included within that level.

(2) Amount represents MSRs accounted for at fair value (see Note 4).

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The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains and losses for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realized or unrealized gains and losses on hedging instruments that have been classified by the Company within the Level 1 and/or Level 2 categories. 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. As a result, the unrealized gains and losses for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value that were attributable to both observable (*e.g.*, changes in market interest rates) and unobservable (*e.g.*, changes in unobservable long-dated volatilities) inputs.

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended February 29, 2008

	Beginning Balance	Realized Gains or (Losses)(1)	Unrealized Gains or (Losses)(1)	Total Realized and Unrealized Gains or (Losses)(1) (dollars in millions)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or Out of Level 3	Ending Balance
Assets							
Financial instruments owned:							
U.S. government and agency securities	\$ 660	\$ 6	\$ 53	\$ 59	\$ (129)	\$ (9)	\$ 581
Other sovereign government obligations	29				(1)	(13)	15
Corporate and other debt(2)	37,058	1,207	(3,413)	(2,206)	(4,413)	1,183	31,622
Corporate equities	1,236	13	(2)	11	819	(109)	1,957
Net derivative contracts (2)(3)	5,938	213	8,391	8,604	1,063	236	15,841
Investments(4)	13,068	(20)	(52)	(72)	778	(1,704)	12,070
Securities received as collateral	7				6		13
Liabilities							
Financial instruments sold, not yet purchased:							
Corporate and other debt(2)	\$ 1,122	\$ (20)	\$ (499)	\$ (519)	\$ (1,036)	\$ (1)	\$ 604
Corporate equities	16	(12)	(92)	(104)	428	4	552
Obligation to return securities received as collateral	7				6		13
Other secured financings	2,321				(705)		1,616
Long-term borrowings(5)	398		(142)	(142)	5,556	(132)	5,964

- (1) Realized and unrealized gains (losses) are included in Principal transactions trading in the condensed consolidated statements of income except for \$(72) million related to Financial instruments owned investments, which is included in Principal transactions investments. Unrealized gains (losses) relate to Level 3 assets and liabilities still held by the Company at February 29, 2008.
- (2) The net gains from Net derivative contracts and the net losses from Corporate and other debt resulted from market movements primarily associated with credit products and various credit linked instruments, respectively. The net gains in Level 3 Net derivative contracts were primarily driven by certain credit default swaps and other instruments associated with the Company's credit products and securitized products activities. The net losses in Level 3 Corporate and other debt were primarily driven by certain asset-backed securities, including residential and commercial mortgage loans, and by corporate loans and loan commitments.

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These results are only a component of the overall trading strategies of these businesses and do not take into consideration any related financial instruments that have been classified by the Company within the Level 1 and/or Level 2 categories. For example, the Company recorded offsetting net losses in Level 2 Net derivative contracts, which were primarily associated with the Company's credit products and securitized products activities.

The Company reclassified certain Corporate and other debt from Level 2 to Level 3 because certain significant inputs for the fair value measurement became unobservable. These reclassifications included transfers primarily related to loans and loan commitments, largely related to corporate lending transactions.

(3) Amounts represent Financial instruments owned derivative contracts net of Financial instruments sold, not yet purchased derivative contracts.

(4) The Company reclassified investments from Level 3 to Level 2 because certain significant inputs for the fair value measurement were identified and, therefore, became observable.

(5) Amounts included in the Purchases, sales, other settlements and issuances, net column primarily relates to the issuance of junior subordinated debentures related to China Investment Corporation investment (see Note 9).

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended February 28, 2007

	Beginning Balance	Realized Gains or (Losses)(1)	Unrealized Gains or (Losses)(1)	Total Realized and Unrealized Gains or (Losses)(1) (dollars in millions)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or Out of Level 3	Ending Balance
Assets							
Financial instruments owned:							
U.S. government and agency securities	\$ 2	\$	\$ (6)	\$ (6)	\$ 152	\$	\$ 148
Other sovereign government obligations	162	2	33	35	682	32	911
Corporate and other debt	33,941	1	(6)	(5)	2,458	(43)	36,351
Corporate equities	1,040	(53)	90	37	170	(8)	1,239
Net derivative contracts (2)(3)	30	(194)	741	547	(335)	34	276
Investments(4)	3,879	27	553	580	1,730	(13)	6,176
Securities received as collateral	40				(40)		
Other assets(5)	2,154	(9)	5	(4)	118		2,268
Liabilities							
Financial instruments sold, not yet purchased:							
Corporate and other debt(2)	\$ 185	\$ (10)	\$ 2	\$ (8)	\$ (167)	\$ 42	\$ 68
Corporate equities	9				1	5	15
Obligation to return securities received as collateral	40				(40)		
Other secured financings	4,724				1,364		6,088
Long-term borrowings	464		(53)	(53)	27		544

(1) Realized and unrealized gains (losses) are included in Principal transactions trading in the condensed consolidated statements of income except for amounts of \$571 million and \$9 million related to Financial instruments owned investments, which are included in Principal transactions investments and Other revenues,

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respectively, and \$(4) million related to Other assets, which are included in Other revenues. Unrealized gains (losses) relate to Level 3 asset and liabilities still held by the Company at February 28, 2007.

- (2) The gains and losses associated with Net derivative contracts were primarily driven by credit products as a result of market movements.
- (3) Amounts represent Financial instruments owned derivative contracts net of Financial instruments sold, not yet purchased derivative contracts.

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(4) The net gains from Financial instruments owned investments were primarily related to investments associated with the Company's real estate funds.

(5) Gains and losses associated with DFS within Other revenues are included in discontinued operations.

Fair Value Option.

The following tables present gains and (losses) due to changes in fair value for items measured at fair value pursuant to the fair value option election for the quarters ended February 29, 2008 and February 28, 2007:

	Principal Transactions: Trading	Net Interest Revenue (dollars in millions)	Gains (losses) Included in the Three Months Ended February 29, 2008(1)
Three months ended February 29, 2008			
Commercial paper and other short-term borrowings	\$ 208	\$ (2)	\$ 206
Deposits	(6)		(6)
Long-term borrowings	464	(198)	266

(1) In addition to these amounts, as discussed in Note 1, all of the instruments within Financial instruments owned or Financial instruments sold, not yet purchased are measured at fair value, either through the election of SFAS No. 159 or as required by other accounting pronouncements. Changes in the fair value of these instruments are recorded in Principal transactions trading and Principal transactions investments revenues.

	Principal Transactions: Trading	Net Interest Revenue (dollars in millions)	(Losses) gains Included in the Three Months Ended February 28, 2007(1)
Three months ended February 28, 2007			
Commercial paper and other short-term borrowings	\$ (5)	\$	\$ (5)
Deposits	4		4
Long-term borrowings	136	(49)	87

(1) In addition to these amounts, as discussed in Note 1, all of the instruments within Financial instruments owned or Financial instruments sold, not yet purchased are measured at fair value, either through the election of SFAS No. 159 or as required by other accounting pronouncements. Changes in the fair value of these instruments are recorded in Principal transactions trading and Principal transactions investments revenues.

As of February 29, 2008 and November 30, 2007, the aggregate contractual principal amount of loans for which the fair value option was elected exceeded the fair value of such loans by approximately \$28,193 million and \$28,880 million, respectively. The aggregate fair value of loans that were 90 or more days past due as of February 29, 2008 and November 30, 2007 was \$2,267 million and \$6,588 million, respectively. The aggregate contractual principal amount of such loans 90 or more days past due exceeded their fair value by approximately \$21,239 million and \$23,501 million at February 29, 2008 and November 30, 2007, respectively. This difference in amount primarily emanates from the Company's distressed debt trading business, which purchases distressed debt at amounts well below par.

For the quarter ended February 29, 2008, changes in the fair value of loans for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were losses of \$2,226 million. Instrument-specific credit losses were determined by excluding the non-credit components of gains and losses, such as those due to changes in interest rates. For the quarter ended February 28, 2007, changes in

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the fair value of loans for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were estimated to be an immaterial unrealized loss.

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For the quarter ended February 29, 2008, the estimated changes in the fair value of the Company's short-term and long-term borrowings, including structured notes and junior subordinated debentures, for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were gains of approximately \$895 million. This gain was attributable to the widening of the Company's credit spreads and was determined based upon observations of the Company's secondary bond market spreads. For the quarter ended February 28, 2007, the estimated changes in the fair value of the Company's short-term and long-term borrowings, including structured notes and junior subordinated debentures, for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were not material. As of February 29, 2008 and November 30, 2007, the aggregate contractual principal amount of long-term debt instruments for which the fair value option was elected exceeded the fair value of such instruments by approximately \$2,955 million and \$1,572 million, respectively.

The estimated change in the fair value of other liabilities for which the fair value option was elected that was attributable to changes in instrument-specific credit spreads was a loss of approximately \$482 million in the quarter ended February 29, 2008. This loss was primarily related to leveraged loan contingent commitments and was attributable to the illiquid market conditions that existed in the quarter. It was generally determined based on the differential between estimated expected client yields at February 29, 2008 and contractual yields. For the quarter ended February 28, 2007, the estimated changes in the fair value of other liabilities for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were not material.

3. Collateralized Transactions.

Securities purchased under agreements to resell (reverse repurchase agreements) and Securities sold under agreements to repurchase (repurchase agreements), principally government and agency securities, are carried at the amounts at which the securities subsequently will be resold or reacquired as specified in the respective agreements; such amounts include accrued interest. Reverse repurchase agreements and repurchase agreements are presented on a net-by-counterparty basis, when appropriate. The Company's policy is to take possession of securities purchased under agreements to resell. Securities borrowed and Securities loaned are carried at the amounts of cash collateral advanced and received in connection with the transactions. Other secured financings include the liabilities related to transfers of financial assets that are accounted for as financings rather than sales, consolidated variable interest entities where the Company is deemed to be the primary beneficiary and certain equity-referenced securities and loans where in all instances these liabilities are payable solely from the cash flows of the related assets accounted for as Financial instruments owned.

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financings. Pledged securities that can be sold or repledged by the secured party are identified as Financial instruments owned (pledged to various parties) in the condensed consolidated statements of financial condition. The carrying value and classification of securities owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge the collateral were as follows:

	At February 29, 2008	At November 30, 2007
	(dollars in millions)	
Financial instruments owned:		
U.S. government and agency securities	\$ 7,655	\$ 7,134
Other sovereign government obligations	6,619	333
Corporate and other debt	43,087	32,530
Corporate equities	3,938	1,133
Total	\$ 61,299	\$ 41,130

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Company's inventory positions. The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed and derivative transactions, and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending and derivative transactions or for delivery to counterparties to cover short positions. At February 29, 2008 and November 30, 2007, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$935 billion and \$948 billion, respectively, and the fair value of the portion that had been sold or repledged was \$721 billion and \$708 billion, respectively.

The Company additionally receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the condensed consolidated statements of financial condition. At February 29, 2008 and November 30, 2007, \$49 billion and \$82 billion, respectively, were reported as Securities received as collateral and an Obligation to return securities received as collateral in the condensed consolidated statements of financial condition. Collateral received in connection with these transactions that was subsequently repledged was approximately \$44 billion and \$72 billion at February 29, 2008 and November 30, 2007, respectively.

The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. For these transactions, adherence to the Company's collateral policies significantly limits the Company's credit exposure in the event of customer default. The Company may request additional margin collateral from customers, if appropriate, and, if necessary, may sell securities that have not been paid for or purchase securities sold but not delivered from customers.

4. Securitization Activities and Variable Interest Entities.

Securitization Activities. The Company engages in securitization activities related to commercial and residential mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, municipal bonds and other types of financial assets. Special purpose entities (SPEs), also known as variable interest entities (VIEs) are typically used in such securitization transactions. Transferred assets are carried at fair value prior to securitization, and any changes in fair value are recognized in the condensed consolidated statements of income. The Company may act as underwriter of the beneficial interests issued by securitization vehicles. Underwriting net revenues are recognized in connection with these transactions. The Company may retain interests in the securitized financial assets as one or more tranches of the securitization. These retained interests are included in the condensed consolidated statements of financial condition at fair value. Any changes in the fair value of such retained interests are recognized in the condensed consolidated statements of income.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Retained interests in securitized financial assets were approximately \$3.5 billion at February 29, 2008, the majority of which were related to residential mortgage loan, commercial mortgage loan and U.S. agency collateralized mortgage obligation securitization transactions. Net gains at the time of securitization were not material in the quarter ended February 29, 2008.

The following table presents information on the Company's residential mortgage loan, commercial mortgage loan and U.S. agency collateralized mortgage obligation securitization transactions. Key economic assumptions and the sensitivity of the current fair value of the retained interests to immediate 10% and 20% adverse changes in those assumptions as of February 29, 2008 were as follows (dollars in millions):

	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations
Investment grade retained interests	\$ 1,264	\$ 760	\$ 491
Non-investment grade retained interests	580	191	
Total retained interests (carrying amount/fair value)	\$ 1,844	\$ 951	\$ 491
Weighted average life (in months)	46	37	44
Range	0.3-146	5.5-119	1.5-268
Weighted average discount rate (per annum)	15.08%	7.86%	6.92%
Range	4.30-124.62%	2.82-27.90%	0.21-40.63%
Impact on fair value of 10% adverse change	\$ (65)	\$ (16)	\$ (8)
Impact on fair value of 20% adverse change	\$ (124)	\$ (30)	\$ (16)
Weighted average credit losses(1)(2)	2.13%	7.10%	0.00%
Range	0.00-12.00%	0.00-25.80%	0.00-0.00%
Impact on fair value of 10% adverse change	\$ (122)	\$ (4)	\$
Impact on fair value of 20% adverse change	\$ (186)	\$ (7)	\$
Weighted average prepayment speed assumption (PSA)(3)(4)	973		359
Range	182-1,500PSA		166-558PSA
Impact on fair value of 10% adverse change	\$ (71)	\$	\$ (7)
Impact on fair value of 20% adverse change	\$ (115)	\$	\$ (15)

(1) Residential mortgage loans credit loss rate stated in terms of cumulative loss rate. Commercial mortgage loans credit loss rate stated in terms of annualized loss rate.

(2) Credit losses are computed only on positions for which expected credit loss is either a key assumption in the determination of fair value or is not reflected in the discount rate.

(3) Amounts for residential mortgage loans exclude positive valuation effects from immediate 10% and 20% changes.

(4) Commercial mortgage loans typically contain provisions that either prohibit or economically penalize the borrower from prepaying the loan for a specified period of time.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The following table presents information on the Company's residential mortgage loan, commercial mortgage loan and U.S. agency collateralized mortgage obligation securitization transactions. Key economic assumptions and the sensitivity of the current fair value of the retained interests to immediate 10% and 20% adverse changes in those assumptions at November 30, 2007 were as follows (dollars in millions):

	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations
Investment grade retained interests	\$ 2,048	\$ 678	\$ 826
Non-investment grade retained interests	1,167	406	
Total retained interests (carrying amount/fair value)	\$ 3,215	\$ 1,084	\$ 826
Weighted average life (in months)	49	57	51
Range	1-322	0.5-139	1-271
Weighted average discount rate (per annum)	12.55%	8.48%	6.04%
Range	1.12 - 74.10%	3.00 - 16.83%	0.75 - 18.12%
Impact on fair value of 10% adverse change	\$ (114)	\$ (14)	\$ (16)
Impact on fair value of 20% adverse change	\$ (218)	\$ (28)	\$ (31)
Weighted average credit losses(1)(2)	4.52%	3.24%	0.00%
Range	0.00 - 12.00%	0.00 - 13.69%	0.00 - 0.00%
Impact on fair value of 10% adverse change	\$ (215)	\$ (5)	\$
Impact on fair value of 20% adverse change	\$ (371)	\$ (10)	\$
Weighted average prepayment speed assumption (PSA)(3)(4)	1,173		301
Range	188 - 2,250PSA		167 - 718PSA
Impact on fair value of 10% adverse change	\$ (118)	\$	\$ (7)
Impact on fair value of 20% adverse change	\$ (194)	\$	\$ (19)

(1) Residential mortgage loans credit loss rate stated in terms of cumulative loss rate. Commercial mortgage loans credit loss rate stated in terms of annualized loss rate.

(2) Credit losses are computed only on positions for which expected credit loss is either a key assumption in the determination of fair value or is not reflected in the discount rate.

(3) Amounts for residential mortgage loans exclude positive valuation effects from immediate 10% and 20% changes.

(4) Commercial mortgage loans typically contain provisions that either prohibit or economically penalize the borrower from prepaying the loan for a specified period of time.

The weighted average assumptions and parameters used initially to value retained interests in relation to securitizations that were still held by the Company as of February 29, 2008 were as follows:

	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations
Weighted average life (in months)	51	44	75
Weighted average discount rate (rate per annum)	10.04%	6.03%	6.29%

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Weighted average credit losses (1)(2)	0.73%	1.51%
Weighted average prepayment speed assumptions	1,628PSA	279PSA

- (1) Residential mortgage loans credit loss rate stated in terms of cumulative loss rate. Commercial mortgage loans credit loss rate stated in terms of annualized loss rate.
- (2) Credit losses are computed only on positions for which expected credit loss is either a key assumption in the determination of fair value or is not reflected in the discount rate.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The tables above do not include the offsetting benefit of any financial instruments that the Company may utilize to hedge risks inherent in its retained interests. In addition, the sensitivity analysis is hypothetical and should be used with caution. Changes in fair value based on a 10% or 20% variation in an assumption generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the retained interests is calculated independently of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. In addition, the sensitivity analysis does not consider any corrective action that the Company may take to mitigate the impact of any adverse changes in the key assumptions.

During the quarters ended February 29, 2008 and February 28, 2007, the Company received proceeds from new securitization transactions of \$3.8 billion and \$14.5 billion, respectively, and cash flows from retained interests in securitization transactions of \$1.7 billion in both periods.

Mortgage Servicing Rights. The Company may retain servicing rights to certain mortgage loans that are sold through its securitization activities. These transactions create an asset referred to as MSRs, which are included within Intangible assets in the condensed consolidated statements of financial condition.

The following table presents information about the Company's MSRs, which relate to its mortgage loan business activities:

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(dollars in millions)	
Fair value as of the beginning of the period	\$ 428	\$ 93
Additions:		
Purchases of servicing assets	1	187
Servicing assets that result from transfers of financial assets	14	50
Total additions	15	237
Subtractions:		
Sales/disposals	(8)	(18)
Changes in fair value(1)	(43)	(25)
Fair value as of the end of the period	\$ 392	\$ 287
Amount of contractually specified(1):		
Servicing fees	\$ 65	\$ 38
Late fees	8	6
Ancillary fees		1
	\$ 73	\$ 45

(1) These amounts are recorded within Other revenues in the Company's condensed consolidated statements of income.

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	Three Months Ended	
	February 29, 2008	February 28, 2007
Assumptions Used in Measuring Fair Value:		
Weighted average discount rate	17.59%	17.87%
Weighted average prepayment speed assumption	584PSA	977PSA

The Company generally utilizes information provided by third parties in order to determine the fair value of its MSR's. The valuation of MSR's consist of projecting servicing cash flows and discounting such cash flows using an appropriate risk-adjusted discount rate. These valuations require estimation of various assumptions, including future servicing fees, credit losses and other related costs, discount rates and mortgage prepayment speeds. The Company also compares the estimated fair values of the MSR's from the valuations with observable trades of similar instruments or portfolios. Due to subsequent changes in economic and market conditions, the actual rates of prepayments, credit losses and the value of collateral may differ significantly from the Company's original estimates. Such differences could be material. If actual prepayment rates and credit losses were higher than those assumed, the value of the Company's MSR's could be adversely affected. The Company may hedge a portion of its MSR's through the use of financial instruments, including certain derivative contracts.

Variable Interest Entities. FASB Interpretation No. 46, as revised (FIN 46R), Consolidation of Variable Interest Entities, applies to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns or both, as a result of holding variable interests. The Company consolidates entities in which it is the primary beneficiary. For those entities deemed to be qualifying special purpose entities (as defined in SFAS No. 140), the Company does not consolidate the entity. See Note 1 regarding the characteristics of QSPes.

The Company is involved with various entities in the normal course of business that may be deemed to be VIEs. The Company's variable interests in VIEs include debt and equity interests, commitments, guarantees and derivative instruments. The Company's involvement with VIEs arises primarily from:

Purchased, sold and retained interests in connection with market making and securitization activities.

Guarantees issued and residual interests retained in connection with municipal bond securitizations.

Loans and investments made to VIEs that hold debt, equity, real estate or other assets.

Derivatives entered into with variable interest entities.

Structuring of credit linked notes or other asset-repackaged notes designed to meet the investment objectives of clients.

Other structured transactions designed to provide enhanced, tax-efficient yields to the Company or its clients.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The following table presents information about the Company's total assets and maximum exposure to loss associated with VIEs as of February 29, 2008 which the Company consolidates. The Company accounts for the assets held by the entities as Financial instruments owned and the liabilities of the entities as Other secured financings in the condensed consolidated statements of financial condition (dollars in millions):

	At February 29, 2008				
	Maximum Exposure to Loss in Consolidated VIEs(1)				
	VIE Assets That the Company Consolidates	Debt and Equity Interests	Derivatives	Commitments and Guarantees	Total
Mortgage and asset-backed securitizations	\$ 7,141	\$ 1,864	\$ 4	\$	\$ 1,868
Municipal bond trusts	811	1		810	811
Credit and real estate(2)	4,608	3,606	2,606		6,212
Commodities financing	1,160		274		274
Other structured transactions	15,257	14,736		9	14,745
	\$ 28,977	\$ 20,207	\$ 2,884	\$ 819	\$ 23,910

- (1) The Company's maximum exposure to loss often differs from the carrying value of the VIE's assets. The maximum exposure to loss is dependent on the nature of the Company's variable interest in the VIEs and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Company has made in the VIEs. Where notional amounts are utilized in quantifying maximum exposure related to derivatives, such amounts do not reflect writedowns already recorded by the Company. The Company's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company may utilize to hedge these risks associated with the Company's variable interests.
- (2) The Company's maximum exposure to loss associated with Credit and real estate VIEs exceeds the consolidated assets of these entities. This is due to the inclusion in this category of certain VIEs that typically hold a limited amount of non-derivative security positions and instead obtain market exposure through the use of derivatives. Given the use of such derivatives, the risk of loss associated with such entities typically exceeds the carrying value of their assets. The Company's maximum exposure to loss associated with such consolidated variable interest entities is generally limited to the notional amount of the Company's derivatives entered into with the VIE and the fair value of any non-derivative security positions held by the Company.

The following table presents information about the Company's total assets and maximum exposure to loss associated with non-consolidated VIEs as of February 29, 2008 in which the Company had significant variable interests (dollars in millions):

	At February 29, 2008				
	Maximum Exposure to Loss in Non-consolidated VIEs (1)				
	VIE Assets That the Company Does not Consolidate	Debt and Equity Interests	Derivatives	Commitments and Guarantees	Total
Mortgage and asset-backed securitizations	\$ 7,475	\$ 136	\$ 108	\$	\$ 244
Municipal bond trusts	801	518		142	660
Credit and real estate	13,351	7,361	703	52	8,116
Other structured transactions	10,457	2,169		414	2,583
	\$ 32,084	\$ 10,184	\$ 811	\$ 608	\$ 11,603

- (1) The Company's maximum exposure to loss often differs from the carrying value of the VIE's assets. The maximum exposure to loss is dependent on the nature of the Company's variable interest in the VIEs and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Company has made in the VIEs. Where notional amounts are utilized in quantifying maximum exposure related to derivatives, such amounts do not reflect writedowns already recorded by the Company. The Company's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company may utilize to hedge these risks associated with the Company's variable interests.

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In the normal course of business, the Company enters into a variety of derivative contracts related to financial instruments and commodities. The Company uses these instruments for trading and investment purposes, as well as for asset and liability management. These instruments generally represent future commitments to swap interest payment streams, exchange currencies, or purchase or sell commodities and other financial instruments on specific terms at specified future dates. Many of these products have maturities that do not extend beyond one year, although swaps, options and equity warrants typically have longer maturities. For further discussion of these matters, refer to Note 6 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2007 (the "Form 10-K").

Future changes in interest rates, foreign currency exchange rates or the fair values of the financial instruments, commodities or indices underlying these contracts ultimately may result in cash settlements exceeding fair value amounts recognized in the condensed consolidated statements of financial condition. The amounts in the following table represent the fair value of exchange traded and OTC options and other contracts (including interest rate, foreign exchange, and other forward contracts and swaps) for derivatives for trading and investment and for asset and liability management, net of offsetting positions in situations where netting is appropriate. The asset amounts are not reported net of non-cash collateral, which the Company obtains with respect to certain of these transactions to reduce its exposure to credit losses. In accordance with the provisions of FSP FIN 39-1, the Company offset cash collateral receivables and payables of \$33 billion and \$45 billion, respectively, against net derivative positions as of February 29, 2008.

Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the contracts reported as assets. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary.

The Company's derivatives (both listed and OTC), net of cash collateral, as of February 29, 2008 and November 30, 2007 are summarized in the table below, showing the fair value of the related assets and liabilities by product:

Product Type	At February 29, 2008		At November 30, 2007	
	Assets	Liabilities	Assets	Liabilities
(dollars in millions)				
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts	\$ 47,776	\$ 29,504	\$ 33,804	\$ 19,515
Foreign exchange forward contracts and options	10,956	10,955	7,755	9,372
Equity securities contracts (including equity swaps, warrants and options)	20,777	30,156	19,913	27,887
Commodity forwards, options and swaps	19,965	18,777	15,531	14,830
Total	\$ 99,474	\$ 89,392	\$ 77,003	\$ 71,604

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(UNAUDITED)

6. Goodwill and Net Intangible Assets.

Changes in the carrying amount of the Company's goodwill and intangible assets for the quarter ended February 29, 2008 were as follows:

	Institutional Securities	Global Wealth Management Group (dollars in millions)	Asset Management	Total
Goodwill:				
Balance as of November 30, 2007	\$ 1,555	\$ 297	\$ 1,172	\$ 3,024
Foreign currency translation adjustments	(2)	6		4
Goodwill acquired during the period and other	28		(3)	25
Balance as of February 29, 2008	\$ 1,581	\$ 303	\$ 1,169	\$ 3,053

Due to the deterioration in the broader credit markets, the Company performed an interim impairment test of goodwill in the first quarter of fiscal 2008, which did not result in an impairment.

	Institutional Securities	Global Wealth Management Group (dollars in millions)	Asset Management	Total
Intangible Assets:				
Amortizable intangible assets at November 30, 2007	\$ 386	\$	\$ 233	\$ 619
Foreign currency translation adjustments	(1)			(1)
Intangible assets acquired during the period and other	24			24
Intangible assets disposed of during the period and other	(8)		(4)	(12)
Amortization expense	(12)		(2)	(14)
Amortizable intangible assets at February 29, 2008	389		227	616
Mortgage servicing rights(see Note 4)	392			392
Balance as of February 29, 2008	\$ 781	\$	\$ 227	\$ 1,008

7. Long-Term Borrowings.

Long-term borrowings at February 29, 2008 scheduled to mature within one year aggregated \$35,386 million.

During the quarter ended February 29, 2008, the Company issued notes with a carrying value at quarter-end aggregating \$15,861 million, including non-U.S. dollar currency notes aggregating \$3,737 million. Maturities in the aggregate of these notes by fiscal year are as follows: 2009, \$2,046 million; 2010, \$1,474 million; 2011, \$716 million; 2012, \$1,338 million; and thereafter, \$10,287 million. In the quarter ended February 29, 2008, \$10,330 million of notes were repaid.

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The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 6.2 years at February 29, 2008.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****8. Commitments, Guarantees and Contingencies.*****Commitments.***

The Company's commitments associated with letters of credit and other financial guarantees obtained to satisfy collateral requirements, investment activities, corporate lending and financing arrangements, and mortgage lending as of February 29, 2008 are summarized below by period of expiration. Since commitments associated with these instruments may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Years to Maturity				Total
	Less than 1	1-3	3-5 (dollars in millions)	Over 5	February 29, 2008
Letters of credit and other financial guarantees obtained to satisfy collateral requirements	\$ 11,719	\$ 11	\$	\$ 1	\$ 11,731
Investment activities	527	220	97	699	1,543
Primary lending commitments(1)	14,687	7,894	26,350	10,594	59,525
Secondary lending commitments(1)	5	17	228	275	525
Commitments for secured lending transactions	2,710	4,143	2,610	23	9,486
Commitments to enter into reverse repurchase agreements	115,036				115,036
Commercial and residential mortgage-related commitments(1)	4,654				4,654
Other commitments	1,062	13	5		1,080
Total	\$ 150,400	\$ 12,298	\$ 29,290	\$ 11,592	\$ 203,580

(1) These commitments are recorded at fair value within Financial instruments owned and Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition (see Note 2).

Letters of Credit and Other Financial Guarantees Obtained to Satisfy Collateral Requirements. The Company has outstanding letters of credit and other financial guarantees issued by third-party banks to certain of the Company's counterparties. The Company is contingently liable for these letters of credit and other financial guarantees, which are primarily used to provide collateral for securities and commodities borrowed and to satisfy various margin requirements in lieu of depositing cash or securities with these counterparties.

Investment Activities. The Company enters into commitments associated with its real estate, private equity and principal investment activities, which include alternative products.

Lending Commitments. Primary lending commitments are those which are originated by the Company whereas secondary lending commitments are purchased from third parties in the market. The commitments include lending commitments that are made to investment grade and non-investment grade companies in connection with corporate lending and other business activities.

Commitments for Secured Lending Transactions. Secured lending commitments are extended by the Company to companies and are secured by real estate or other physical assets of the borrower. Loans made under these arrangements typically are at variable rates and generally provide for over-collateralization based upon the

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(UNAUDITED)

creditworthiness of the borrower. This amount also includes commitments to asset-backed commercial paper conduits of \$590 million as of February 29, 2008, which have maturities of less than four years.

Commitments to Enter into Reverse Repurchase Agreements. The Company enters into forward starting securities purchased under agreements to resell that are primarily secured by collateral from U.S. government agency securities and other sovereign government obligations.

Commercial and Residential Mortgage-Related Commitments. The Company enters into forward purchase contracts involving residential mortgage loans, residential mortgage loan commitments to individuals and residential home equity lines of credit. In addition, the Company enters into commitments to originate commercial and residential mortgage loans.

Other Commitments. Other commitments include commercial loan commitments to small businesses and commitments related to securities-based lending activities in connection with the Company's Global Wealth Management Group business segment.

Guarantees.

The table below summarizes certain information regarding the Company's obligations under guarantee arrangements at February 29, 2008:

Type of Guarantee	Maximum Potential Payout/Notional Years to Maturity				Total	Carrying Amount	Collateral/ Recourse
	Less than 1	1-3	3-5	Over 5			
	(dollars in millions)						
Notional amount of derivative contracts	\$ 948,925	\$ 1,174,956	\$ 2,834,213	\$ 2,135,215	\$ 7,093,309	\$ 426,538	\$ 46
Standby letters of credit and other financial guarantees issued(1)	619	1,018	2,516	7,823	11,976	9	4,804
Market value guarantees	108	76		653	837	66	145
Liquidity facilities(2)	19,371	1,598	803	425	22,197	22	20,224
General partner guarantees	47	111	40	306	504	14	

(1) Approximately \$5 billion of standby letters of credit are also reflected in the Commitments table above in primary and secondary lending commitments.

(2) The maximum potential payout amount includes liquidity facilities to asset-backed commercial paper conduits of \$714 million.

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The Company has certain obligations under certain guarantee arrangements, including contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying measure (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or non-occurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. Also included as guarantees are contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement, as well as indirect guarantees of the indebtedness of others. The Company's use of guarantees is described below by type of guarantee:

Derivative Contracts. Certain derivative contracts meet the accounting definition of a guarantee, including certain written options, contingent forward contracts and credit default swaps. Although the Company's derivative arrangements do not specifically identify whether the derivative counterparty retains the underlying asset, liability or equity security, the Company has disclosed information regarding all derivative contracts that could meet the accounting definition of a guarantee. The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated, as increases in interest or foreign exchange rates in the future could possibly be unlimited. Therefore, in order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed.

The Company records all derivative contracts at fair value. Aggregate market risk limits have been established, and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies, including, but not limited to, entering into offsetting economic hedge positions. The Company believes that the notional amounts of the derivative contracts generally overstate its exposure.

Standby Letters of Credit and other Financial Guarantees Issued. In connection with its corporate lending business and other corporate activities, the Company provides standby letters of credit and other financial guarantees to counterparties. Such arrangements represent obligations to make payments to third parties if the counterparty fails to fulfill its obligation under a borrowing arrangement or other contractual obligation.

Market Value Guarantees. Market value guarantees are issued to guarantee return of principal invested to fund investors associated with certain European equity funds and to guarantee timely payment of a specified return to investors in certain affordable housing tax credit funds. The guarantees associated with certain European equity funds are designed to provide for any shortfall between the market value of the underlying fund assets and invested principal and a stipulated return amount. The guarantees provided to investors in certain affordable housing tax credit funds are designed to return an investor's contribution to a fund and the investor's share of tax losses and tax credits expected to be generated by a fund.

Liquidity Facilities. The Company has entered into liquidity facilities with SPEs and other counterparties, whereby the Company is required to make certain payments if losses or defaults occur. Primarily, the Company acts as liquidity provider to municipal bond securitization SPEs and for standalone municipal bonds in which the holders of beneficial interests issued by these SPEs or the holders of the individual bonds, respectively, have the right to tender their interests for purchase by the Company on specified dates at a specified price. The Company often may have recourse to the underlying assets held by the SPEs in the event payments are required under such liquidity facilities as well as make-whole or recourse provisions with the trust sponsors.

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General Partner Guarantees. As a general partner in certain private equity and real estate partnerships, the Company receives distributions from the partnerships according to the provisions of the partnership agreements. The Company may, from time to time, be required to return all or a portion of such distributions to the limited partners in the event the limited partners do not achieve a certain return as specified in various partnership agreements, subject to certain limitations.

Other Guarantees and Indemnities.

In the normal course of business, the Company provides a variety of other guarantees and indemnifications, which are described below.

Trust Preferred Securities. The Company has established Morgan Stanley Trusts for the limited purpose of issuing trust preferred securities to third parties and lending the proceeds to the Company in exchange for junior subordinated debentures. The Company has directly guaranteed the repayment of the trust preferred securities to the holders thereof to the extent that the Company has made payments to a Morgan Stanley Trust on the junior subordinated debentures. In the event that the Company does not make payments to a Morgan Stanley Trust, holders of such series of trust preferred securities would not be able to rely upon the guarantee for payment of those amounts. The Company has not recorded any liability in the condensed consolidated financial statements for these guarantees and believes that the occurrence of any events (*i.e.*, nonperformance on the part of the paying agent) that would trigger payments under these contracts is remote. See Note 13 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Form 10-K for details on the Company's junior subordinated debentures.

Indemnities. The Company provides standard indemnities to counterparties for certain contingent exposures and taxes, including U.S. and foreign withholding taxes, on interest and other payments made on derivatives, securities and stock lending transactions, certain annuity products and other financial arrangements. These indemnity payments could be required based on a change in the tax laws or change in interpretation of applicable tax rulings or a change in factual circumstances. Certain contracts contain provisions that enable the Company to terminate the agreement upon the occurrence of such events. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these indemnifications and believes that the occurrence of any events that would trigger payments under these contracts is remote.

Exchange/Clearinghouse Member Guarantees. The Company is a member of various U.S. and non-U.S. exchanges and clearinghouses that trade and clear securities and/or futures contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse. While the rules governing different exchange or clearinghouse memberships vary, in general the Company's guarantee obligations would arise only if the exchange or clearinghouse had previously exhausted its resources. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these agreements and believes that any potential requirement to make payments under these agreements is remote.

Securitized Asset Guarantees. As part of the Company's Institutional Securities securitization activities, the Company provides representations and warranties that certain securitized assets conform to specified guidelines. The Company may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines. Due diligence is performed by the Company to ensure that asset guideline qualifications are met, and, to the extent the Company has acquired such assets to be securitized from other parties, the Company seeks to obtain its own representations and warranties regarding the assets. The

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maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of all assets subject to such securitization activities. Also, in connection with originations of residential mortgage loans under the Company's FlexSource® program, the Company may permit borrowers to pledge marketable securities as collateral instead of requiring cash down payments for the purchase of the underlying residential property. Upon sale of the residential mortgage loans, the Company may provide a surety bond that reimburses the purchasers for shortfalls in the borrowers' securities accounts up to certain limits if the collateral maintained in the securities accounts (along with the associated real estate collateral) is insufficient to cover losses that purchasers experience as a result of defaults by borrowers on the underlying residential mortgage loans. The Company requires the borrowers to meet daily collateral calls to ensure the marketable securities pledged in lieu of a cash down payment are sufficient. At February 29, 2008 and November 30, 2007, the maximum potential amount of future payments the Company may be required to make under its surety bond was \$133 million and \$122 million, respectively. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these representations and warranties and reimbursement agreements and believes that the probability of any payments under these arrangements is remote.

Merger and Acquisition Guarantees. The Company may, from time to time, in its role as investment banking advisor be required to provide guarantees in connection with certain European merger and acquisition transactions. If required by the regulating authorities, the Company provides a guarantee that the acquirer in the merger and acquisition transaction has or will have sufficient funds to complete the transaction and would then be required to make the acquisition payments in the event the acquirer's funds are insufficient at the completion date of the transaction. These arrangements generally cover the time frame from the transaction offer date to its closing date and, therefore, are generally short term in nature. The maximum potential amount of future payments that the Company could be required to make cannot be estimated. The Company believes the likelihood of any payment by the Company under these arrangements is remote given the level of the Company's due diligence associated with its role as investment banking advisor.

Contingencies.

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 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

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after consultation with counsel, that the outcome of such pending matters will not have a material adverse effect on the condensed 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 or income for such period. Legal reserves have been established in accordance with SFAS No. 5, *Accounting for Contingencies* (SFAS No. 5). Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

9. Shareholders' Equity.

Regulatory Requirements. MS&Co. is a registered broker-dealer and registered futures commission merchant and, accordingly, subject to the minimum net capital requirements of the Securities and Exchange Commission (the SEC), the Financial Industry Regulatory Authority and the Commodity Futures Trading Commission. MS&Co. has consistently operated in excess of these requirements. MS&Co.'s net capital totaled \$9,131 million at February 29, 2008, which exceeded the amount required by \$6,866 million. MSIP, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Authority, and MSJS, a Tokyo-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Agency. MSIP and MSJS consistently operated in excess of their respective regulatory capital requirements.

Under regulatory capital requirements adopted by the Federal Deposit Insurance Corporation (the FDIC) and other bank regulatory agencies, FDIC-insured financial institutions must maintain (a) 3% to 4% of Tier 1 capital, as defined, to average assets (leverage ratio), (b) 4% of Tier 1 capital, as defined, to risk-weighted assets (Tier 1 risk-weighted capital ratio) and (c) 8% of total capital, as defined, to risk-weighted assets (total risk-weighted capital ratio). At February 29, 2008, the leverage ratio, Tier 1 risk-weighted capital ratio and total risk-weighted capital ratio of each of the Company's FDIC-insured financial institutions exceeded these regulatory minimums.

Certain other U.S. and non-U.S. subsidiaries are subject to various securities, commodities and banking regulations, and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. These subsidiaries have consistently operated in excess of their local capital adequacy requirements.

Morgan Stanley Derivative Products Inc. (MSDP) and Cournot Financial Products LLC (Cournot), which are triple-A rated derivative products subsidiaries, maintain certain operating restrictions that have been reviewed by various rating agencies. Both entities are operated such that creditors of the Company should not expect to have any claims on either the assets of MSDP or the assets of Cournot, unless and until the obligations of such entity to its own creditors are satisfied in full. Creditors of MSDP or Cournot, respectively, should not expect to have any claims on the assets of the Company or any of its affiliates, other than the respective assets of MSDP or Cournot.

The Company is a consolidated supervised entity (CSE) as defined by the SEC. As such, the Company is subject to group-wide supervision and examination by the SEC and to minimum capital requirements on a consolidated basis. As of February 29, 2008, the Company was in compliance with the CSE capital requirements.

MS&Co. is required to hold tentative net capital in excess of \$1 billion and net capital in excess of \$500 million in accordance with the market and credit risk standards of Appendix E of Rule 15c3-1. MS&Co. is also required to notify the SEC in the event that its tentative net capital is less than \$5 billion. As of February 29, 2008, MS&Co. had tentative net capital in excess of the minimum and the notification requirements.

Treasury Shares. During the quarter ended February 29, 2008, the Company did not purchase any of its common stock through the open market share repurchase program. During the quarter ended February 28, 2007, the Company purchased approximately \$1.2 billion of its common stock through open market purchases at an average cost of \$82.02 per share.

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China Investment Corporation Investment. In December 2007, the Company sold Equity Units which included contracts to purchase Company common stock to a wholly owned subsidiary of China Investment Corporation ("CIC"), for approximately \$5,579 million. CIC's ownership in the Company's common stock, including the maximum number of shares of common stock to be received by CIC upon settlement of the stock purchase contracts, will be 9.9% or less of the Company's total shares outstanding based on the total shares that were outstanding on November 30, 2007. CIC is a passive financial investor and has no special rights of ownership nor a role in the management of the Company. A substantial portion of the investment proceeds were treated as Tier 1 capital for regulatory capital purposes.

The present value of the future contract adjustment payments due under the stock purchase contracts was approximately \$400 million and was recorded in Other liabilities and accrued expenses with a corresponding decrease recorded in Paid-in capital, a component of Shareholders' equity in the Company's condensed consolidated statement of financial condition in the first quarter of fiscal 2008. The other liability balance related to the stock purchase contracts will accrete over the term of the stock purchase contract using the effective yield method with a corresponding charge to Interest expense. When the contract adjustment payments are made under the stock purchase contracts, they will reduce the other liability balance.

For a more detailed summary of the Equity Units, including the junior subordinated debentures issued to support trust common and trust preferred securities and the stock purchase contracts, refer to Note 28 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Form 10-K.

Prior to the issuance of common stock upon settlement of the stock purchase contract, the impact of the Equity Units are reflected in the Company's earnings per diluted common share using the treasury stock method, as defined by SFAS No. 128, "Earnings Per Share." Under the treasury stock method, the number of shares of common stock included in the calculation of earnings per diluted common share are calculated as the excess, if any, of the number of shares expected to be issued upon settlement of the stock purchase contract based on the average market price for the last 20 days of the reporting period, less the number of shares that could be purchased by the Company with the proceeds to be received upon settlement of the contract at the average closing price for the reporting period.

Dilution of net income per share occurs (i) in reporting periods when the average closing price of common shares is over \$57.6840 per share or (ii) in reporting periods when the average closing price of common shares for a reporting period is between \$48.0700 and \$57.6840 and is greater than the average market price for the last 20 days ending three days prior to the end of such reporting period.

The dilutive impact for the first quarter of fiscal 2008 was approximately 256,000 shares.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****10. Earnings per Common Share.**

Basic earnings per share (EPS) is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the assumed conversion of all dilutive securities. The following table presents the calculation of basic and diluted EPS (in millions, except for per share data):

	Three Months Ended	
	February 29, 2008	February 28, 2007
Basic EPS:		
Income from continuing operations	\$ 1,551	\$ 2,314
Gain on discontinued operations, net		358
Preferred stock dividend requirements	(17)	(17)
Net income applicable to common shareholders	\$ 1,534	\$ 2,655
Weighted average common shares outstanding	1,021	1,009
Earnings per basic common share:		
Income from continuing operations	\$ 1.50	\$ 2.28
Gain on discontinued operations		0.35
Earnings per basic common share	\$ 1.50	\$ 2.63
Diluted EPS:		
Net income applicable to common shareholders	\$ 1,534	\$ 2,655
Weighted average common shares outstanding	1,021	1,009
Effect of dilutive securities:		
Stock options and restricted stock units	37	49
Weighted average common shares outstanding and common stock equivalents	1,058	1,058
Earnings per diluted common share:		
Income from continuing operations	\$ 1.45	\$ 2.17
Gain on discontinued operations		0.34
Earnings per diluted common share	\$ 1.45	\$ 2.51

The following securities were considered antidilutive and, therefore, were excluded from the computation of diluted EPS:

Three Months Ended

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	February 29, 2008	February 28, 2007
	(shares in millions)	
Number of antidilutive securities (including stock options and restricted stock units) outstanding at end of period	60	16

Cash dividends declared per common share were \$0.27 for the quarters ended February 29, 2008 and February 28, 2007.

For information on the dilutive impact related to CIC, see Note 9.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****11. Employee Benefit Plans.**

The Company maintains various pension and benefit plans for eligible employees.

The components of the Company's net periodic benefit expense for its pension and postretirement plans were as follows:

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(dollars in millions)	
Service cost, benefits earned during the period	\$ 28	\$ 29
Interest cost on projected benefit obligation	36	33
Expected return on plan assets	(33)	(31)
Net amortization of actuarial loss	8	10
Net amortization of prior-service credit	(2)	(2)
Net periodic benefit expense	\$ 37	\$ 39

12. Income Taxes.

The Company adopted FIN 48 on December 1, 2007 and recorded a cumulative effect adjustment of approximately \$92 million as a decrease to the opening balance of Retained earnings as of December 1, 2007.

The total amount of unrecognized tax benefits as of the date of adoption of FIN 48 was approximately \$2.7 billion. Of this total, approximately \$1.7 billion (net of federal benefit of state issues, competent authority and foreign tax credit offsets) represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate in future periods.

The Company recognizes the accrual of interest related to unrecognized tax benefits in Provision for income taxes in the condensed consolidated statements of income. The Company recognizes the accrual of penalties (if any) related to unrecognized tax benefits in income before income taxes. Interest expense included in income taxes as of December 1, 2007 was approximately \$223 million, net of federal and state income tax benefits. The amount of penalties accrued is immaterial.

It is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur within the next twelve months. It is difficult to estimate the range of such changes; however, the Company does not expect that any change in the gross balance of unrecognized tax benefits would have a material impact on its effective tax rate over the next twelve months.

The Company is under continuous examination by the Internal Revenue Service (the IRS) and other tax authorities in certain countries, such as Japan and the United Kingdom, and states in which the Company has significant business operations, such as New York. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years examinations. The Company has established unrecognized tax benefits that the Company believes are adequate in relation to the potential for additional assessments. Once established, the Company adjusts unrecognized tax benefits only when more information is available or when an event occurs necessitating a change. The Company believes that the resolution of tax matters will not have a material effect on the condensed consolidated statements of financial condition of the Company, although a resolution could have a material impact on the Company's condensed consolidated statements of income for a particular future period and on the Company's effective income tax rate for any period in which such resolution occurs.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

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

Jurisdiction	Tax Year
United States	1999
New York State and City	2002
Hong Kong	2001
United Kingdom	2004
Japan	2004

13. Segment Information.

The Company structures its segments primarily based upon the nature of the financial products and services provided to customers and the Company's management organization. The Company provides a wide range of financial products and services to its customers in each of its business segments: Institutional Securities, Global Wealth Management Group and Asset Management. For further discussion of the Company's business segments, see Note 1.

Revenues and expenses directly associated with each respective segment are included in determining their operating results. Other revenues and expenses that are not directly attributable to a particular segment are allocated based upon the Company's allocation methodologies, generally based on each segment's respective net revenues, non-interest expenses or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the business segment results to the Company's consolidated results. Income before taxes in Intersegment Eliminations primarily represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Asset Management to the Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to the Global Wealth Management Group's global representatives.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

Selected financial information for the Company's segments is presented below:

Three Months Ended February 29, 2008	Institutional Securities	Global Wealth		Intersegment Eliminations	Total
		Management Group	Asset Management (dollars in millions)		
Net revenues excluding net interest	\$ 5,313	\$ 1,395	\$ 566	\$ (55)	\$ 7,219
Net interest	900	211	(23)	15	1,103
Net revenues	\$ 6,213	\$ 1,606	\$ 543	\$ (40)	\$ 8,322
Income from continuing operations before losses from unconsolidated investees and income taxes	\$ 2,117	\$ 254	\$ (161)	\$ 4	\$ 2,214
Gains from unconsolidated investees	2				2
Provision for (benefit from) income taxes	627	95	(58)	1	665
Income from continuing operations	\$ 1,492	\$ 159	\$ (103)	\$ 3	\$ 1,551

Three Months Ended February 28, 2007	Institutional Securities	Global Wealth		Intersegment Eliminations	Total
		Management Group	Asset Management (dollars in millions)		
Net revenues excluding net interest	\$ 6,332	\$ 1,375	\$ 1,371	\$ (57)	\$ 9,021
Net interest	830	136	(3)	10	973
Net revenues	\$ 7,162	\$ 1,511	\$ 1,368	\$ (47)	\$ 9,994
Income from continuing operations before losses from unconsolidated investees and income taxes	\$ 2,845	\$ 226	\$ 379	\$ 6	\$ 3,456
Losses from unconsolidated investees	(26)				(26)
Provision for income taxes	878	87	149	2	1,116
Income from continuing operations(1)	\$ 1,941	\$ 139	\$ 230	\$ 4	\$ 2,314

Net Interest	Institutional Securities	Global Wealth			Total
		Management Group	Asset Management (dollars in millions)	Intersegment Eliminations	
Three Months Ended February 29, 2008					
Interest and dividends	\$ 13,660	\$ 302	\$ 15	\$ (12)	\$ 13,965
Interest expense	12,760	91	38	(27)	12,862

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Net interest	\$ 900	\$ 211	\$ (23)	\$ 15	\$ 1,103
Three Months Ended February 28, 2007					
Interest and dividends	\$ 14,021	\$ 274	\$ 14	\$ (138)	\$ 14,171
Interest expense	13,191	138	17	(148)	13,198
Net interest	\$ 830	\$ 136	\$ (3)	\$ 10	\$ 973

Total Assets(2)	Institutional Securities	Global Wealth		Total
		Management Group	Asset Management	
		(dollars in millions)		
At February 29, 2008	\$ 1,052,488	\$ 26,632	\$ 11,776	\$ 1,090,896
At November 30, 2007	\$ 1,005,452	\$ 27,518	\$ 12,439	\$ 1,045,409

- (1) See Note 14 for a discussion of discontinued operations.
(2) Corporate assets have been fully allocated to the Company's business segments.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The Company operates in both U.S. and non-U.S. markets. The Company's non-U.S. business activities are principally conducted through European and Asian locations. The following table presents selected income statement information of the Company's operations by geographic area. The net revenues disclosed in the following table reflect the regional view of the Company's consolidated net revenues, on a managed basis, based on the following methodology:

Institutional Securities: investment banking client location, equity capital markets client location, debt capital markets revenue recording location, sales & trading trading desk location.

Global Wealth Management Group: global representative coverage location.

Asset Management: client location, except for the merchant banking business, which is based on asset location.

Net Revenues	Americas	Europe, Middle East and Africa (dollars in millions)	Asia	Total
Three Months Ended February 29, 2008	\$ 3,823	\$ 3,267	\$ 1,232	\$ 8,322
Three Months Ended February 28, 2007	6,072	2,702	1,220	9,994

14. Discontinued Operations.

Discover. On June 30, 2007, the Company completed the Discover Spin-off. The Company distributed all of the outstanding shares of DFS common stock, par value \$0.01 per share, to the Company's stockholders of record as of June 18, 2007. The results of DFS prior to the Discover Spin-off are included within discontinued operations for the three months ended February 28, 2007.

Net revenues included in discontinued operations related to DFS were \$1,025 million for the three months ended February 28, 2007.

The results of discontinued operations include interest expense that was allocated based upon borrowings that were specifically attributable to DFS operations through intercompany transactions existing prior to the Discover Spin-off. For the three months ended February 28, 2007, the amount of interest expense reclassified to discontinued operations was approximately \$88 million.

Quilter. On February 28, 2007, the Company sold Quilter, its standalone U.K. mass affluent business that was formerly included within the Global Wealth Management Group business segment. The results of Quilter are included within discontinued operations for the three months ended February 28, 2007. The results for discontinued operations in the quarter ended February 28, 2007 also included a pre-tax gain of \$168 million (\$109 million after-tax) on disposition.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Summarized financial information for the Company's discontinued operations:

The table below provides information regarding amounts included within discontinued operations for the three months ended February 28, 2007 (dollars in millions):

Pre-tax gain on discontinued operations	
DFS	\$ 390
Quilter	174
	\$ 564

15. Business Disposition.

Morgan Stanley Wealth Management S.V., S.A.U. On January 28, 2008, the Company announced that it had reached an agreement to sell Morgan Stanley Wealth Management S.V., S.A.U. (MSWM), its Spanish onshore mass affluent wealth management business. The transaction closed during the second quarter of fiscal 2008. The results of MSWM are included within the Global Wealth Management Group business segment.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Morgan Stanley:

We have reviewed the accompanying condensed consolidated statement of financial condition of Morgan Stanley and subsidiaries (the Company) as of February 29, 2008, and the related condensed consolidated statements of income, comprehensive income and cash flows for the three-month periods ended February 29, 2008 and February 28, 2007. These interim financial statements are the responsibility of the management of the Company.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of the Company as of November 30, 2007, and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders' equity for the fiscal year then ended (not presented herein) included in Morgan Stanley's Annual Report on Form 10-K; and in our report dated January 28, 2008, which report contains an explanatory paragraph relating to the adoption, in fiscal 2005, of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment and effective December 1, 2005, the change in accounting policy for recognition of equity awards granted to retirement-eligible employees, an explanatory paragraph relating to, in fiscal 2006, the application of Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, an explanatory paragraph relating to the adoption, in fiscal 2007, of SFAS No. 157, Fair Value Measurements and SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 and an explanatory paragraph relating to the adoption, in fiscal 2007, of SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R), we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial condition as of November 30, 2007 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

As discussed in Note 1 and in Note 12 to the condensed consolidated interim financial statements, effective December 1, 2007, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109.

/s/ Deloitte & Touche LLP
New York, New York
April 7, 2008

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. Introduction.

Morgan Stanley (the Company) is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Global Wealth Management Group and Asset Management. The Company, through its subsidiaries and affiliates, provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. A summary of the activities of each of the segments follows.

Institutional Securities includes capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; benchmark indices and risk management analytics; research; and investment activities.

Global Wealth Management Group provides brokerage and investment advisory services covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; cash management services; retirement services; and trust and fiduciary services.

Asset Management provides global asset management products and services in equity, fixed income, alternative investments, which includes hedge funds and funds of funds, and merchant banking, which includes real estate, private equity and infrastructure, to institutional and retail clients through proprietary and third-party distribution channels. Asset Management also engages in investment activities.

The discussion of the Company's results of operations below may contain forward-looking statements. These statements, which reflect management's beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect the Company's future results, please see Forward-Looking Statements immediately preceding Part I, Item 1, Competition and Regulation in Part I, Item 1, Risk Factors in Part I, Item 1A and Certain Factors Affecting Results of Operations in Part II, Item 7 and other items throughout the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2007 (the Form 10-K) and the Company's 2008 Current Reports on Form 8-K.

The Company's results of operations for the three month periods ended February 29, 2008 and February 28, 2007 are discussed below.

Discontinued Operations.

On June 30, 2007, the Company completed the spin-off (the Discover Spin-off) of Discover Financial Services (DFS) to its shareholders. DFS results are included within discontinued operations for the first quarter of fiscal 2007. The results of Quilter Holdings Ltd. (Quilter), Global Wealth Management Group's former mass affluent business in the U.K., are also reported as discontinued operations for the first quarter of fiscal 2007. See Note 14 to the condensed consolidated financial statements.

Table of Contents**Results of Operations.****Executive Summary.*****Financial Information.***

	As of or for the Three Months Ended	
	February 29, 2008	February 28, 2007
Net revenues (dollars in millions):		
Institutional Securities	\$ 6,213	\$ 7,162
Global Wealth Management Group	1,606	1,511
Asset Management	543	1,368
Intersegment Eliminations	(40)	(47)
Consolidated net revenues	\$ 8,322	\$ 9,994
Income (loss) before income taxes (dollars in millions)(1):		
Institutional Securities	\$ 2,117	\$ 2,845
Global Wealth Management Group	254	226
Asset Management	(161)	379
Intersegment Eliminations	4	6
Consolidated income before taxes	\$ 2,214	\$ 3,456
Consolidated net income (dollars in millions)	\$ 1,551	\$ 2,672
Earnings applicable to common shareholders (dollars in millions)(2)	\$ 1,534	\$ 2,655
Earnings per basic common share:		
Income from continuing operations	\$ 1.50	\$ 2.28
Gain on discontinued operations		0.35
Earnings per basic common share	\$ 1.50	\$ 2.63
Earnings per diluted common share:		
Income from continuing operations	\$ 1.45	\$ 2.17
Gain on discontinued operations		0.34
Earnings per diluted common share	\$ 1.45	\$ 2.51
Regional net revenues (dollars in millions)(3):		
Americas	\$ 3,823	\$ 6,072
Europe, Middle East and Africa	3,267	2,702
Asia	1,232	1,220
Consolidated net revenues	\$ 8,322	\$ 9,994

Statistical Data.

Book value per common share(4)	\$ 29.11	\$ 34.71
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Average common equity (dollars in billions)(5):

Institutional Securities	\$ 24.4	\$ 20.0
Global Wealth Management Group	1.5	1.7
Asset Management	3.8	3.0
Total from operating segments	29.7	24.7
Discontinued operations		5.7
Unallocated capital	1.5	5.1
Consolidated	\$ 31.2	\$ 35.5

Table of Contents*Statistical Data (Continued).*

	As of or for the Three Months Ended	
	February 29, 2008	February 28, 2007
Return on average common equity(5):		
Consolidated	20%	30%
Institutional Securities	24%	38%
Global Wealth Management Group	42%	32%
Asset Management	N/M	31%
Effective income tax rate from continuing operations	30.0%	32.5%
Worldwide employees	47,050	44,797
Consolidated assets under management or supervision by asset class (dollars in billions):		
Equity	\$ 317	\$ 317
Fixed income	124	111
Money market	117	90
Alternatives(6)	111	77
Subtotal	669	595
Unit trusts	14	15
Other(7)	59	59
Total assets under management or supervision(8)	742	669
Share of minority interest assets(9)	7	5
Total	\$ 749	\$ 674
Institutional Securities:		
Mergers and acquisitions completed transactions (dollars in billions)(10):		
Global market volume	\$ 103.4	\$ 153.6
Market share	27.6%	30.0%
Rank	4	2
Mergers and acquisitions announced transactions (dollars in billions)(10):		
Global market volume	\$ 88.1	\$ 226.9
Market share	23.5%	40.5%
Rank	2	1
Global equity and equity-related issues (dollars in billions)(10):		
Global market volume	\$ 2.6	\$ 6.0
Market share	3.9%	5.6%
Rank	10	8
Global debt issues (dollars in billions)(10):		
Global market volume	\$ 45.1	\$ 71.3
Market share	5.3%	5.5%
Rank	5	6
Global initial public offerings (dollars in billions)(10):		
Global market volume	\$ 0.5	\$ 1.8
Market share	3.7%	7.1%
Rank	8	5
Pre-tax profit margin(11)	34%	40%

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Statistical Data (Continued).

	As of or for the Three Months Ended	
	February 29, 2008	February 28, 2007
Global Wealth Management Group:		
Global representatives	8,456	7,993
Annualized net revenue per global representative (dollars in thousands)(12)	\$ 761	\$ 758
Client assets by segment (dollars in billions):		
\$10 million or more	\$ 229	\$ 210
\$1 million \$10 million	262	248
Subtotal \$1 million or more	491	458
\$100,000 \$1 million	175	174
Less than \$100,000	23	26
Client assets excluding corporate and other accounts	689	658
Corporate and other accounts	33	32
Total client assets	\$ 722	\$ 690
Fee-based assets as a percentage of total client assets(13)	26%	29%
Client assets per global representative (dollars in millions)(14)	\$ 85	\$ 86
Bank deposits (dollars in billions)(15)	\$ 33.4	\$ 16.4
Pre-tax profit margin(11)	16%	15%
Asset Management:		
Assets under management or supervision (dollars in billions)(16)	\$ 577	\$ 521
Percent of fund assets in top half of Lipper rankings(17)	48%	48%
Pre-tax profit margin(11)	N/M	28%

N/M Not Meaningful

- (1) Amounts represent income from continuing operations before gains (losses) from unconsolidated investees, income taxes and gain from discontinued operations.
- (2) Earnings applicable to common shareholders are used to calculate earnings per share information. The three months ended February 29, 2008 and February 28, 2007 reflect a preferred stock dividend of \$17 million.
- (3) Reflects the regional view of the Company's consolidated net revenues, on a managed basis, based on the following methodology:
Institutional Securities: investment banking client location, equity capital markets client location, debt capital markets revenue recording location, sales and trading trading desk location. Global Wealth Management Group: global representative coverage location. Asset Management: client location, except for the merchant banking business, which is based on asset location.
- (4) Book value per common share equals common shareholders' equity of \$32,180 million at February 29, 2008 and \$36,854 million at February 28, 2007, divided by common shares outstanding of 1,105 million at February 29, 2008 and 1,062 million at February 28, 2007.
- (5) The computation of average common equity for each business segment is based upon an economic capital framework that estimates the amount of equity capital required to support the businesses over a wide range of market environments while simultaneously satisfying regulatory, rating agency and investor requirements. The economic capital framework will evolve over time in response to changes in the business and regulatory environment and to improvements in modeling techniques. The effective tax rates used in the computation of segment return on average common equity were determined on a separate entity basis.
- (6) Amounts reported for Alternatives include the Company's invested equity in those funds and include a range of alternative investment products such as real estate funds, hedge funds, private equity funds, funds of hedge funds and funds of private equity funds.
- (7) Amounts include assets under management or supervision associated with the Global Wealth Management Group business segment.
- (8) Revenues and expenses associated with these assets are included in the Company's Asset Management, Global Wealth Management Group and Institutional Securities business segments.
- (9) Amounts represent Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (10)

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Source: Thomson Financial, data as of March 5, 2008 The data for the three months ended February 29, 2008 and February 28, 2007 are for the periods from January 1 to February 29, 2008 and January 1 to February 28, 2007, respectively, as Thomson Financial presents these data on a calendar-year basis.

- (11) Percentages represent income from continuing operations before losses from unconsolidated investees and income taxes, as a percentage of net revenues.
- (12) Annualized net revenue per global representative amounts equal Global Wealth Management Group's net revenues divided by the quarterly average global representative headcount for the periods presented.

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- (13) The decline in fee-based assets as a percent of total client assets largely reflected the termination on October 1, 2007 of the Company's fee-based (fee-in-lieu of commission) brokerage program pursuant to a court decision vacating a Securities and Exchange Commission (SEC) rule that permitted fee-based brokerage. Client assets that were in the fee-based program primarily moved to commission-based brokerage accounts, or at the election of some clients, into other fee-based advisory programs, including Morgan Stanley Advisory, a new nondiscretionary account launched in August 2007.
- (14) Client assets per global representative equal total period-end client assets divided by period-end global representative headcount.
- (15) Bank deposits are held at certain of the Company's Federal Deposit Insurance Corporation (the FDIC) insured depository institutions for the benefit of retail clients through their accounts.
- (16) Amounts include Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (17) Source: Lipper, one-year performance excluding money market funds as of February 29, 2008 and February 28, 2007, respectively.

First Quarter 2008 Performance.

Company Results. The Company recorded net income of \$1,551 million in the quarter ended February 29, 2008, a 42% decrease from the comparable fiscal 2007 period. Net revenues (total revenues less interest expense) declined 17% to \$8,322 million. Non-interest expenses of \$6,108 million, including severance expense of approximately \$161 million related to staff reductions, decreased 7% from the first quarter of last year primarily due to lower compensation and benefits costs. Diluted earnings per share were \$1.45 compared with \$2.51 in last year's first quarter. Compensation and benefits expense decreased 15%, primarily reflecting lower incentive-based compensation accruals due to lower net revenues in the Company's Institutional Securities and Asset Management business segments. Diluted earnings per share from continuing operations were \$1.45 compared with \$2.17 in last year's first quarter. The annualized return on average common equity was 19.7% compared with 29.9% in the first quarter of last year. The return on average common equity from continuing operations was 19.7% compared with 30.9% in the first quarter of last year.

Results for the first quarter of fiscal 2007 included a gain of \$168 million (\$109 million after-tax) in discontinued operations related to the sale of Quilter on February 28, 2007 (see Note 14 to the condensed consolidated financial statements).

The Company's effective income tax rate from continuing operations was 30.0% for the first quarter of fiscal 2008 compared with 32.5% for the first quarter of fiscal 2007. The decrease primarily reflected a change in the geographic mix of earnings, partially offset by an increase in the rate due to lower domestic tax credits.

In December 2007, the Company sold equity units (the Equity Units) to a wholly owned subsidiary of the China Investment Corporation Ltd. (CIC) for approximately \$5,579 million (see Liquidity and Capital Resources China Investment Corporation Investment herein).

At February 29, 2008, the Company had 47,050 employees worldwide compared with 44,797 (excluding DFS employees) at the end of the first quarter of last year and 48,256 at November 30, 2007.

Institutional Securities. Institutional Securities recorded income from continuing operations before gains (losses) from unconsolidated investees and income taxes of \$2,117 million, a 26% decrease from last year's first quarter. Net revenues declined 13% to \$6,213 million as lower results in fixed income sales and trading and underwriting transactions more than offset record results in equity sales and trading. Non-interest expenses decreased 5% to \$4,096 million from last year's first quarter, reflecting lower compensation costs, partially offset by higher costs associated with higher levels of business activity.

Investment banking revenues decreased 5% from the first quarter of fiscal 2007 to \$980 million. Underwriting revenues decreased 19% to \$536 million due to a decline in market activity. Advisory fees from merger, acquisition and restructuring transactions were \$444 million, an increase of 19% from the comparable period of fiscal 2007, reflecting higher revenues from completed transactions.

Equity sales and trading revenues increased 51% to a record \$3,329 million. Strong trading results in a volatile market coupled with increased customer flows contributed to record results in derivatives and higher revenues in cash equity products. Prime brokerage also generated record net revenues for the quarter. Equity sales and

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trading revenues also benefited by approximately \$321 million from the widening of the Company's credit spreads on certain long-term and short-term borrowings that are accounted for at fair value. Fixed income sales and trading revenues were \$2,907 million, 15% below the record \$3,430 million in the first quarter of fiscal 2007, as record revenues in interest rate, credit and currency products and higher revenues from commodities products were partially offset by net writedowns on mortgage proprietary trading products. Interest rate, credit and currency trading products generated higher revenues from strong customer flows and higher levels of volatility, and emerging markets generated record revenues. Credit trading also benefited from favorable positioning as credit spreads widened during the quarter. Commodities revenues benefited from strong customer flows and were higher than last year's first quarter as higher trading revenues in agricultural products and oil liquids were partly offset by lower revenues in electricity and natural gas products. Fixed income sales and trading also benefited by approximately \$527 million from widening of the Company's credit spreads on certain long-term and short-term borrowings that are accounted for at fair value.

In the first quarter of fiscal 2008, other sales and trading losses of \$1,102 million reflected writedowns on loans and commitments largely related to event-driven lending transactions to non-investment grade companies and the writedown of mortgage-related securities portfolios in the Company's domestic subsidiary banks (see *Impact of Credit Market Events* herein).

Principal transaction net investment losses aggregating \$141 million were recognized in the quarter ended February 29, 2008 as compared with net investment gains of \$350 million in the quarter ended February 28, 2007. The decrease was primarily related to net losses from the Company's investments in passive limited partnership interests associated with the Company's real estate funds and investments related to certain employee deferred compensation and co-investment plans.

Global Wealth Management Group. Global Wealth Management Group recorded income from continuing operations before income taxes of \$254 million, up 12% from the first quarter of fiscal 2007. Net revenues were \$1,606 million, a 6% increase from last year's first quarter, primarily reflecting higher net interest revenue from growth in the bank deposit program and higher client activity. Total non-interest expenses were \$1,352 million, a 5% increase from last year's first quarter. Compensation and benefits expense increased 10%, primarily reflecting higher incentive-based compensation accruals due to higher net revenues and severance-related expenses. Non-compensation costs decreased 7%, as higher levels of business activity were more than offset by a change in the classification of sub-advisory fees due to modifications of certain customer agreements. Total client assets increased to \$722 billion, a 5% increase from last year's first quarter. In addition, client assets in fee-based accounts decreased 8% from last year's first quarter to \$185 billion and decreased as a percentage of total client assets to 26% from 29%. The decline in fee-based assets as a percent of total client assets largely reflected the termination on October 1, 2007 of the Company's fee-based (fee-in-lieu of commission) brokerage program pursuant to a court decision vacating an SEC rule that permitted fee-based brokerage. At February 29, 2008, the number of global representatives was 8,456, an increase of 463 from a year ago.

Asset Management. Asset Management recorded a loss before income taxes of \$161 million in the first quarter of fiscal 2008 as compared with income before income taxes of \$379 million in the first quarter of last year. Net revenues of \$543 million decreased 60% from last year's first quarter, primarily due to principal transaction net investment losses in real estate, including those associated with deferred compensation and co-investment plans, as compared with net gains recorded in the first quarter of fiscal 2007. The current quarter also included principal transaction trading losses of approximately \$187 million related to securities issued by structured investment vehicles. These decreases were partly offset by higher asset management, distribution and administration fees resulting primarily from an increase in assets under management and a more favorable asset mix. Non-interest expenses decreased 29% to \$704 million from last year's first quarter. Compensation and benefits expense decreased primarily due to lower net revenues and lower expenses associated with the Company's employee deferred compensation plans. Non-compensation expenses increased from a year ago reflecting higher levels of business activity. Assets under management or supervision within Asset Management of \$577 billion were up \$56 billion, or 11%, from a year ago, primarily driven by increases in the alternative and money market asset classes related to positive net customer inflows.

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Global Market and Economic Conditions in the Quarter Ended February 29, 2008.

In the U.S., the slowdown of economic growth that occurred during the second half of fiscal 2007 continued during the first quarter of fiscal 2008. Significant and broad-based illiquidity in the residential real estate and credit markets continued to stress financial markets. Continued concerns about the impact of subprime loans caused the subprime-related and broader credit markets to deteriorate further over the course of the quarter. The U.S. unemployment rate at the end of the first quarter of fiscal 2008 increased to 4.8% from 4.7% at the end of fiscal 2007. During the quarter, the U.S. dollar weakened against most major currencies. Conditions in the U.S. equity markets were also volatile and major equity market indices declined during the quarter, primarily as a result of concerns about future economic growth, record oil prices, lower consumer sentiment, the adverse developments in the credit markets and mixed corporate earnings. The Federal Reserve Board (the "Fed") lowered both the benchmark interest rate and discount rate by an aggregate of 1.50% during the first quarter of fiscal 2008, including an unscheduled 0.75% interest rate reduction in January 2008. The Fed acted to continue to provide additional liquidity and stability to the financial markets and to contain the negative economic impact related to the residential real estate and credit markets. Although providing liquidity and stability to the financial markets is a primary objective, the Fed also remains concerned about inflationary pressures. Subsequent to quarter end, the Fed lowered both the benchmark interest rate and discount rate by an additional 0.75% in order to provide increased liquidity to the financial markets. In March 2008, the Fed also announced new lending facilities, which are now available to primary broker-dealers in an additional effort to restore liquidity within the securities industry. Also in March 2008, the Fed lowered the primary credit rate by 0.25%. The Fed continues to consult frequently with its central bank counterparts in Europe and North America to address liquidity pressures within the capital markets.

In Europe, the strong pace of economic growth that occurred in fiscal 2007 showed signs of slowing during the first quarter of fiscal 2008 as export demand decreased, the Euro strengthened against the U.S. dollar and the disruption in the global financial markets continued. Major equity market indices in Europe decreased during the first quarter of fiscal 2008, primarily due to concerns about the economic outlook and difficult conditions in the credit markets. The European Central Bank left the benchmark interest rate unchanged during the first quarter of fiscal 2008, while the Bank of England reduced the benchmark interest rate by an aggregate of 0.50%.

In Japan, economic growth moderated as demand for exports were adversely impacted by a stronger Japanese yen against the U.S. dollar. The level of unemployment remained relatively low. Japanese equity market indices decreased during the first quarter of fiscal 2008 amid tighter global credit conditions. The Bank of Japan left the benchmark interest rate unchanged during the first quarter of fiscal 2008. Economies elsewhere in Asia expanded, particularly in China, which benefited from strength in exports, domestic demand for capital projects and continued globalization. In China, equity market indices declined during the first quarter of fiscal 2008. In addition, the People's Bank of China raised the benchmark lending rate by 0.18%.

Business Segments.

The remainder of "Results of Operations" is presented on a business segment basis before discontinued operations. Substantially all of the Company's operating revenues and operating expenses can be directly attributed to its business segments. Certain revenues and expenses have been allocated to each business segment, generally in proportion to its respective net revenues, non-interest expenses or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the business segment results to the Company's consolidated results. Income before taxes in Intersegment Eliminations primarily represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Asset Management to the Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to the Global Wealth Management Group's global representatives. Income before taxes recorded in Intersegment Eliminations was \$4 million in the quarter ended February 29, 2008 and \$6 million in the quarter ended February 28, 2007.

Table of Contents**INSTITUTIONAL SECURITIES****INCOME STATEMENT INFORMATION**

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(dollars in millions)	
Revenues:		
Investment banking	\$ 980	\$ 1,032
Principal transactions:		
Trading	3,394	4,029
Investments	(141)	350
Commissions	840	691
Asset management, distribution and administration fees	31	25
Interest and dividends	13,660	14,021
Other	209	205
 Total revenues	 18,973	 20,353
Interest expense	12,760	13,191
 Net revenues	 6,213	 7,162
 Total non-interest expenses	 4,096	 4,317
 Income from continuing operations before gains (losses) from unconsolidated investees and income taxes	 2,117	 2,845
Gains (losses) from unconsolidated investees	2	(26)
Provision for income taxes	627	878
 Income from continuing operations	 \$ 1,492	 \$ 1,941

Investment Banking. Investment banking revenues for the quarter ended February 29, 2008 decreased 5% from the comparable period of fiscal 2007. The decrease was due to lower revenues from fixed income and equity underwriting transactions, partially offset by higher revenues from merger, acquisition and restructuring activities. Advisory fees from merger, acquisition and restructuring transactions were \$444 million, an increase of 19% from the comparable period of fiscal 2007, reflecting higher revenues from completed transactions. Underwriting revenues were \$536 million, a decrease of 19% from the comparable period of fiscal 2007. Equity underwriting revenues decreased 13% to \$261 million. Fixed income underwriting revenues decreased 23% to \$275 million. The decrease in underwriting activity was consistent with a decline in industry-wide activity.

At February 29, 2008, the backlog for investment banking transactions remained relatively robust given market conditions that continue to be challenging. The backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions is subject to the risk that transactions may not be completed due to challenging or unforeseen economic and market conditions, adverse developments regarding one of the parties to the transaction, a failure to obtain required regulatory approval or a decision on the part of the parties involved not to pursue a transaction.

Sales and Trading. Sales and trading revenues are composed of principal transaction trading revenues, commissions and net interest revenues (expenses). In assessing the profitability of its sales and trading activities, the Company views principal trading, commissions and net interest revenues in the aggregate. In addition, decisions relating to principal transactions are based on an overall review of aggregate revenues and costs associated with each transaction or series of transactions. This review includes, among other things, an assessment of the potential gain or loss associated with a transaction, including any associated commissions, dividends, the interest income or expense associated with financing or hedging the Company's positions, and other related expenses.

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Total sales and trading revenues decreased 7% from the comparable period of fiscal 2007. Lower fixed income sales and trading revenues and increased net losses from other sales and trading revenues were partially offset by record equity sales and trading revenues.

Sales and trading revenues include the following:

	Three Months Ended	
	February 29, 2008(1)	February 28, 2007(1)
	(dollars in millions)	
Equity	\$ 3,329	\$ 2,209
Fixed income	2,907	3,430
Other	(1,102)	(89)
Total sales and trading revenues	\$ 5,134	\$ 5,550

(1) Amounts include Principal transactions trading, Commissions and Net interest revenues. Other sales and trading net revenues primarily include net losses from loans and closed pipeline commitments related to investment banking, corporate lending and other corporate activities.

Equity sales and trading revenues increased 51% to a record \$3,329 million. The increase was driven by record revenues from derivative products and prime brokerage and higher revenues from equity cash and financing products, partially offset by lower revenues from principal trading strategies. Revenues from derivative products and equity cash products benefited from strong customer flows and higher market volatility. Record prime brokerage revenues reflected continued growth in global client asset balances. Higher revenues from financing products were primarily due to higher commission revenues driven by strong market volumes. Equity sales and trading revenues also benefited from the widening of the Company's credit spreads on financial instruments that are accounted for at fair value, including, but not limited to, those for which the fair value option was elected pursuant to Statement of Financial Accounting Standards (SFAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159) on December 1, 2006 (see Note 2 to the condensed consolidated financial statements). Revenues included approximately \$321 million due to the widening of the Company's credit spreads during the quarter resulting from the decrease in the fair value of certain of the Company's long-term and short-term borrowings, such as structured notes, for which the fair value option was elected.

Fixed income sales and trading revenues were \$2,907 million, 15% lower than the first quarter of fiscal 2007. The first quarter of fiscal 2008 reflected record results in interest rate, credit and currency products and higher revenues from commodities, partially offset by losses in residential and commercial mortgage loan products. Writedowns on mortgage proprietary trading products of \$1.2 billion were primarily due to a broadening decline in the residential and commercial mortgage sector. The decline in the Company's residential mortgage loan activities reflected the difficult market conditions, as well as continued concerns in the subprime mortgage loan sector. See Impact of Credit Market Events herein, detailing the Company's direct U.S. subprime mortgage-related exposures at February 29, 2008.

Interest rate, credit and currency product revenues increased 46%, reflecting higher revenues from interest rate, credit and foreign exchange products and record revenues in emerging markets, partially offset by writedowns related to exposure to monoline insurers (see Impact of Credit Market Events Monoline Insurers herein). Revenues from interest rate and credit trading products benefited from strong customer flows and higher levels of market volatility. Higher revenues from credit trading products also reflected favorable positioning as credit spreads widened during the first quarter of fiscal 2008. Commodity revenues benefited from strong customer flows and increased 25%, primarily due to higher trading results from agricultural products and oil liquids, partially offset by lower revenues from electricity and natural gas products. Fixed income sales and trading revenues also benefited from the widening of the Company's credit spreads on financial instruments that are accounted for at fair value, including, but not limited to, those for which the fair value option was elected (see

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Note 2 to the condensed consolidated financial statements). Revenues increased by approximately \$527 million due to the widening of the Company's credit spreads during the quarter resulting from the decrease in the fair value of certain of the Company's long-term and short-term borrowings, such as structured notes, for which the fair value option was elected.

In addition to the equity and fixed income sales and trading revenues discussed above, sales and trading revenues include the net revenues from the Company's corporate lending activities. In the first quarter of fiscal 2008, other sales and trading losses were \$1,102 million. Included in the \$1,102 million were net losses of approximately \$910 million (mark-to-market valuations of approximately \$2.1 billion, net of gains on hedges of approximately \$1.2 billion) associated with loans and commitments largely related to event-driven lending to non-investment grade companies and the writedown of securities in the Company's domestic subsidiary banks (see *Impact of Credit Market Events* herein). The losses included markdowns of leveraged loan commitments associated with acquisition financing transactions that were accepted by the borrower but not yet closed. These losses were primarily related to the illiquid market conditions that existed during the first quarter of fiscal 2008. The valuation of these commitments could change in future periods depending on, among other things, the extent that they are renegotiated or repriced or if the associated acquisition transaction does not occur. In addition, the Company's leveraged finance business originates and distributes loans and commitments and intends to distribute its current positions; however, this is taking longer than in the past. Widening credit spreads for non-investment grade loans could result in additional writedowns for these loans and commitments. The fair value measurement of loan commitments takes into account certain fee income that is attributable to the contingent commitment contract. For further information about the Company's corporate lending activities, see Item 3, *Quantitative and Qualitative Disclosures about Market Risk* *Credit Risk*.

Principal Transactions Investments. Principal transaction net investment losses aggregating \$141 million were recognized in the quarter ended February 29, 2008 as compared with net investment gains of \$350 million in the quarter ended February 28, 2007. The decrease was primarily related to net losses from the Company's investments in passive limited partnership interests associated with the Company's real estate funds and investments related to certain employee deferred compensation and co-investment plans.

Other. Other revenues increased 2%. The increase was primarily attributable to higher sales of benchmark indices and risk management analytic products, partially offset by lower revenues related to the operation of pipelines, terminals and barges and the distribution of refined petroleum products associated with TransMontaigne and lower revenues associated with Saxon.

Non-Interest Expenses. Non-interest expenses decreased 5%, primarily reflecting a decrease in compensation and benefits expense, partially offset by higher non-compensation expenses. Compensation and benefits expense decreased 15%, primarily reflecting lower incentive-based compensation accruals due to lower net revenues, partially offset by severance-related expenses of \$130 million recorded in the first quarter of fiscal 2008. Excluding compensation and benefits expense, non-interest expenses increased 24%, reflecting increased levels of business activity. Brokerage, clearing and exchange fees increased 25%, primarily reflecting substantially increased equity and fixed income trading activity. Information processing and communications expense increased 15%, primarily due to higher market data and data processing costs. Marketing and business development expense increased 24%, primarily due to a higher level of business activity. Other expenses increased 66%, primarily reflecting higher regulatory and litigation costs.

Table of Contents**GLOBAL WEALTH MANAGEMENT GROUP****INCOME STATEMENT INFORMATION**

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(dollars in millions)	
Revenues:		
Investment banking	\$ 104	\$ 166
Principal transactions:		
Trading	177	129
Investments	(4)	(2)
Commissions	363	315
Asset management, distribution and administration fees	716	729
Interest and dividends	302	274
Other	39	38
Total revenues	1,697	1,649
Interest expense	91	138
Net revenues	1,606	1,511
Total non-interest expenses	1,352	1,285
Income from continuing operations before income taxes	254	226
Provision for income taxes	95	87
Income from continuing operations	\$ 159	\$ 139

Investment Banking. Investment banking revenues decreased 37%, primarily due to lower underwriting activity across equity and unit trust products, partially offset by an increase in fixed income underwriting activity. The first quarter of fiscal 2007's equity underwriting results included a significant closed end fund offering.

Principal Transactions Trading. Principal transaction trading revenues increased 37%, primarily due to higher revenues from municipal, government and corporate fixed income securities, partially offset by losses associated with investments related to certain employee deferred compensation plans.

Commissions. Commission revenues increased 15% reflecting higher client activity.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees decreased 2%, primarily reflecting the discontinuance of certain fee-based brokerage programs in the fourth quarter of fiscal 2007 and a change in the classification of sub-advisory fees due to modifications of certain customer agreements, partially offset by growth in other fee-based products.

Client assets in fee-based accounts decreased 8% to \$185 billion at February 29, 2008 and represented 26% of total client assets compared with 29% at February 28, 2007. The decline in fee-based assets as a percent of total client assets largely reflected the termination on October 1, 2007 of the Company's fee-based (fee-in-lieu of commission) brokerage program pursuant to a court decision vacating an SEC rule that permitted fee-based brokerage. Client assets that were in the fee-based program primarily moved to commission-based brokerage accounts, or, at the election of some clients, into other fee-based advisory programs, including Morgan Stanley Advisory, a nondiscretionary account launched in August 2007. Total client asset balances increased to \$722 billion at February 29, 2008 from \$690 billion at February 28, 2007, primarily due to higher client inflows. Client asset balances in households greater than \$1 million increased to \$491 billion at February 29, 2008 from \$458 billion at February 28, 2007.

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Net Interest. Net interest revenues increased 55%, primarily due to increased customer account balances in the bank deposit program. Balances in the bank deposit program rose to \$33.4 billion at February 29, 2008 from \$16.4 billion at February 28, 2007.

Non-Interest Expenses. Non-interest expenses increased 5%, primarily reflecting an increase in compensation and benefits expense, partially offset by lower non-compensation expenses. Compensation and benefits expense increased 10%, primarily reflecting higher incentive-based compensation accruals related to higher net revenues and severance-related expenses of \$19 million recorded in the first quarter of fiscal 2008. Excluding compensation and benefits expense, non-interest expenses decreased 7%. Occupancy and equipment increased 6%, primarily due to an increase in space costs and branch renovations. Marketing and business development expense increased 14%, primarily due to a higher level of business activity. Professional service expenses decreased 32%, primarily due to the change in the classification of sub-advisory fees relating to certain customer agreements. Other expenses increased 6%, primarily due to an increase in the reserve for debit card fraud and higher FDIC insurance premiums related to the bank deposit program, partially offset by lower litigation expenses.

Table of Contents**ASSET MANAGEMENT****INCOME STATEMENT INFORMATION**

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(dollars in millions)	
Revenues:		
Investment banking	\$ 26	\$ 31
Principal transactions:		
Trading	(179)	
Investments	(201)	532
Commissions	4	6
Asset management, distribution and administration fees	845	768
Interest and dividends	15	14
Other	71	34
 Total revenues	 581	 1,385
Interest expense	38	17
 Net revenues	 543	 1,368
 Total non-interest expenses	 704	 989
 (Loss) income before income taxes	 (161)	 379
(Benefit from) provision for income taxes	(58)	149
 Net income (loss)	 \$ (103)	 \$ 230

Investment Banking. Investment banking revenues decreased 16%, primarily reflecting lower revenues from certain merchant banking products and unit trust sales.

Principal Transactions Trading. The first quarter of fiscal 2008 primarily included losses of \$187 million related to structured investment vehicles. See [Impact of Credit Market Events](#) [Structured Investment Vehicles](#) herein for further discussion.

Principal Transactions Investments. Principal transaction net investment losses aggregating \$201 million were recognized in the first quarter of fiscal 2008 as compared with gains of \$532 million in the prior-year period. The current quarter included net investment losses associated with the Company's real estate products, including those associated with deferred compensation and co-investment plans and alternative investments and lower investment gains in the Company's private equity portfolio.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees increased 10%, primarily due to higher fund management and administration fees resulting from an increase in assets and a more favorable asset mix. Average assets under management increased 14% to \$585 billion as of February 29, 2008 from the prior-year period average of \$512 billion. The increase was partially offset by lower performance fees from the alternatives business and lower distribution fees.

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Asset Management's period-end and average customer assets under management or supervision were as follows:

	Average for the Three Months Ended			
	February 29, 2008	February 28, 2007	February 29, 2008	February 28, 2007
	(dollars in billions)			
Assets under management or supervision by distribution channel:				
Americas Retail Morgan Stanley brand	\$ 58	\$ 62	\$ 61	\$ 62
Americas Retail Van Kampen brand	88	96	94	96
Americas Intermediary(1)	64	61	66	60
U.S. Institutional	123	110	125	107
Non-U.S.	128	102	129	97
Total long-term assets under management or supervision	461	431	475	422
Institutional money markets/liquidity	76	52	71	51
Retail money markets	33	33	32	34
Total money markets	109	85	103	85
Total assets under management or supervision	570	516	578	507
Share of minority interest assets(2)	7	5	7	5
Total	\$ 577	\$ 521	\$ 585	\$ 512
Assets under management or supervision by asset class:				
Equity	\$ 235	\$ 245	\$ 249	\$ 244
Fixed income	101	94	102	93
Money market	109	85	103	85
Alternatives(3)	111	77	110	71
Subtotal	556	501	564	493
Unit trusts	14	15	14	14
Total assets under management or supervision	570	516	578	507
Share of minority interest assets(2)	7	5	7	5
Total	\$ 577	\$ 521	\$ 585	\$ 512

(1) Americas Intermediary channel primarily represents client flows through defined contribution, insurance and bank trust platforms.

(2) Amounts represent Asset Management's proportional share of assets managed by entities in which it owns a minority interest.

(3) The alternatives asset class includes a range of investment products, such as real estate funds, hedge funds, private equity funds, funds of hedge funds and funds of private equity funds.

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Activity in Asset Management's assets under management or supervision were as follows:

	Three Months Ended	
	February 29, 2008	February 28, 2007
	(dollars in billions)	
Balance at beginning of period	\$ 597	\$ 496
Net flows by distribution channel:		
Americas Retail Morgan Stanley brand	(2)	(2)
Americas Retail Van Kampen brand	(3)	
Americas Intermediary(1)	1	1
U.S. Institutional	1	
Non-U.S.		5
Net (outflows)/inflows excluding money markets	(3)	4
Money market net flows:		
Institutional	8	3
Retail	1	(2)
Total money market net flows	9	1
Net market (depreciation)/appreciation	(26)	14
Total net (decrease)/increase	(20)	19
Acquisitions		6
Balance at end of period	\$ 577	\$ 521

(1) Americas Intermediary channel primarily represents client flows through defined contribution, insurance and bank trust platforms.

Net outflows (excluding money markets) during the quarter ended February 29, 2008 were primarily associated with Americas Retail Morgan Stanley and Van Kampen brand products, partially offset by positive flows into Americas Intermediary and U.S. Institutional products. Money market net flows for the quarter were primarily associated with positive flows into institutional liquidity assets.

Other. Other revenues increased 109%, primarily due to revenues associated with Lansdowne Partners (Lansdowne), a London-based investment manager in which the Company has a minority interest.

Non-Interest Expenses. Non-interest expenses decreased 29%, primarily reflecting a decrease in compensation and benefits expense. Compensation and benefits expense decreased 46%, primarily reflecting lower incentive-based compensation accruals due to lower net revenues and lower expenses associated with certain employee deferred compensation plans. Excluding compensation and benefits expense, non-interest expenses increased 6%. Brokerage, clearing and exchange fees increased 11%, primarily due to increased fee sharing related to increased assets under management. Professional services expense decreased 19%, primarily due to lower sub-advisory fees. Other expenses increased 38%, primarily due to higher minority interest and other miscellaneous expense.

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Impact of Credit Market Events.

Overview.

The systematic risk reduction in the markets that occurred in the latter half of fiscal 2007 continued in the first quarter of fiscal 2008 after an extended period of global liquidity and historically low interest rates. Continued concerns about the impact of subprime loans caused the subprime-related and broader credit markets to deteriorate further, with lower levels of liquidity and price transparency for certain credit products. These difficult market conditions adversely affected event-driven lending transactions, U.S. subprime and non-subprime residential mortgage products, commercial real estate products, structured investment vehicles and monoline insurers.

The results for the first quarter of fiscal 2008 included net losses of approximately \$910 million (mark-to-market valuations of approximately \$2.1 billion net of gains on hedges of approximately \$1.2 billion) associated with loans and loan commitments largely related to event-driven lending transactions to non-investment grade companies. The losses included markdowns of leveraged loan commitments associated with event-driven lending transactions that were accepted by the borrower but not yet closed. These losses were primarily related to the illiquid market conditions that existed during the first quarter of fiscal 2008. The valuation of these commitments could change in future periods depending on, among other things, the extent that they are renegotiated or repriced or the associated acquisition transaction does not occur. In addition, the Company's leveraged finance business originates and distributes loans and commitments, and intends to distribute its current positions; however, this is taking longer than in the past. Widening credit spreads for non-investment grade loans could result in additional writedowns for these loans and commitments. For further information about the Company's corporate lending activities, see Item 3, Quantitative and Qualitative Disclosures about Market Risk - Credit Risk.

In the first quarter of fiscal 2008, the Company recorded mortgage proprietary trading net writedowns of approximately \$1.2 billion, half of which was related to U.S. subprime exposures. The \$1.2 billion reflected net writedowns on U.S. subprime trading positions including super senior derivative positions and subprime residuals. The \$1.2 billion also included net writedowns on non-subprime residential mortgages. See Non-subprime Residential Mortgages and Commercial Mortgage-backed Securities herein.

In addition, the Company recorded writedowns of approximately \$204 million related to mortgage-related securities portfolios in the Company's domestic subsidiary banks (see Subsidiary Banks herein).

The Company also recognized losses of \$187 million in the first quarter of fiscal 2008 related to investments issued by structured investment vehicles (see Structured Investment Vehicles herein).

The Company continues to have exposure to real estate and lending-related markets and instruments, and, as market conditions continue to evolve, the fair value of these other positions could further deteriorate (see Results of Operations Asset Management herein for discussion of losses related to real estate products). Additionally, given the current challenges in the financial markets, it is possible that declines in the estimated fair value of the Company's businesses may occur which could result in a future goodwill impairment charge.

U.S. Subprime Mortgage-Related Exposures.

The Company's U.S. subprime mortgage-related trading positions consist of those related to U.S. ABS CDOs and other mortgage-related exposures arising from investments in subprime loans, from asset-backed securities that, in whole or in part, are backed by subprime mortgage loans, and from derivatives referencing subprime mortgages or subprime mortgage-backed securities.

Subprime mortgages are loans secured by real property made to a borrower (or borrowers) with a diminished or impaired credit rating or with a limited credit history. A borrower's credit history is reflected in his credit report

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and routinely converted into a numerical credit score often referred to as a Fair Isaac Corporation (or FICO) score. Generally, a loan made to a borrower with a low FICO score or other credit score has historically been considered as subprime. Loans to borrowers with higher FICO scores may be subprime if the loan exhibits other high-risk factors. Such risk factors may include loans where: (a) the loan has a high loan-to-value ratio or combined loan-to-value ratios; (b) the borrower has reduced or limited income documentation; (c) the borrower has a high debt-to-income ratio; or (d) the occupancy type for the loan is other than the borrower's primary residence. There are many other risk factors, including borrowers who have purchased multiple properties or have taken previous equity withdrawal (cash out) refinancings within the last 12 to 24 month period, non-arm's length purchase transactions and unsupported or high-risk collateral properties, among others. Subprime mortgage-related securities are those securities that derive a significant portion of their value from subprime loans.

U.S. ABS CDO Exposures.

The Company purchases interests in and enters into derivatives with ABS CDOs. CDOs provide credit risk exposure to a portfolio of asset-backed securities (cash CDOs) or a reference portfolio of securities (synthetic CDOs). The underlying or reference portfolios consist primarily of residential mortgage-backed securities. The CDOs to which the Company has exposure are primarily structured and underwritten by third parties, although the Company also structures and underwrites CDOs, for which it receives structuring and/or distribution fees, and does from time to time retain interests in such CDOs.

The Company's primary exposure to ABS CDOs is to synthetic CDOs that hold or are referenced to collateral with ratings of BBB+, BBB or BBB- (mezzanine CDOs). Under these credit default swap arrangements, the Company can be required to make payments in the event that securities in the referenced portfolios default or experience other credit events such as rating agency downgrades. (The characterization of these credit default swaps as super senior derives from their seniority in the capital structure of the synthetic CDO.) The Company also has exposure to ABS CDOs via other types of credit default swaps, direct investments in CDO securities, and retained interests in CDOs that the Company has underwritten. In determining the fair value of the Company's ABS CDO-related instruments the Company took into consideration prices observed from the execution of a limited number of transactions and data for relevant benchmark instruments in synthetic subprime markets. Despite the fact that actual defaults on swap obligations have not yet been realized, the fair value of such positions has experienced significant declines as a result of a deterioration of value in the benchmark instruments as well as market developments. These losses, as well as the Company's net CDO exposures, are quantified in the U.S. subprime-related exposures table below.

Other U.S. Subprime Mortgage-Related Exposures.

The Company also has exposure to the U.S. subprime mortgage market via investments in subprime mortgage loans and ABS that are backed in whole or in part by subprime mortgage loans and via derivatives referencing subprime mortgages or subprime mortgage-backed securities. With respect to whole loans, the Company purchases pools of mortgage loans from third-party originators and also originates mortgage loans through its retail channel and typically disposes of such loans by securitizing them. The Company typically retains certain lower-rated securities of such securitizations, often referred to as residual tranche securities. The Company's other subprime mortgage-related trading exposures are quantified in the table below.

The Company's interests in U.S. subprime-related exposures are carried at fair value with changes recognized in earnings. The valuation methodology used for these instruments incorporated a variety of inputs, including prices observed from the execution of a limited number of trades in the marketplace; ABX and similar indices that track the performance of a series of credit default swaps based on subprime mortgages; and other market information, including data on remittances received and updated cumulative loss data on the underlying mortgages. For a further discussion of the Company's risk management policies and procedures see Quantitative and Qualitative Disclosures about Market Risk Risk Management in Part II, Item 7A of the Form 10-K.

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The following table provides a summary of the Company's direct U.S. subprime trading exposures (excluding amounts related to mortgage-related securities portfolios in the Company's domestic subsidiary banks (see "Subsidiary Banks" herein)) as of and for the fiscal quarter ended February 29, 2008. Net exposure as of November 30, 2007 is also presented. The Company utilizes various methods of evaluating risk in its trading and other portfolios, including monitoring Net Exposure. Net Exposure is defined as potential loss to the Company over a period of time in an event of 100% default of the referenced loan, assuming zero recovery. The value of these positions remains subject to mark-to-market volatility. Positive net exposure amounts indicate potential loss (long position) in a default scenario. Negative net exposure amounts indicate potential gain (short position) in a default scenario. Net Exposure does not take into consideration the risk of counterparty default such that actual losses could exceed the amount of Net Exposure. See Note 1 to the condensed consolidated financial statements for a description regarding valuation of these instruments. See "Quantitative and Qualitative Disclosures about Market Risk - Credit Risk" in Part II, Item 7A of the Form 10-K for a further description of how credit risk is monitored.

	Statement of Financial Condition February 29, 2008(1)	Profit and (Loss) Three Months Ended February 29, 2008	Net Exposure February 29, 2008	Net Exposure November 30, 2007
(dollars in billions)				
Super Senior Derivative Exposure:				
Mezzanine	\$ (8.5)	\$ (0.5)	\$ 2.8	\$ 3.9
CDO squared(3)				0.1
Total ABS CDO super senior derivative exposure	\$ (8.5)	\$ (0.5)	\$ 2.8	\$ 4.0
Other CDO Exposure:				
ABS CDO CDS	\$ 2.4	\$ 0.5	\$ (1.0)	\$ (1.5)
ABS CDO bonds	0.8	(0.2)	0.8	1.1
Total other CDO exposure	\$ 3.2	\$ 0.3	\$ (0.2)	\$ (0.4)
Subtotal ABS CDO-related exposure(2)	\$ (5.3)	\$ (0.2)	\$ 2.6	\$ 3.6
U.S. Subprime Mortgage-Related Exposure:				
Loans	\$ 0.5	\$	\$ 0.5	\$ 0.6
Total rate-of-return swaps			0.1	
ABS bonds	1.9	(0.4)	1.9	2.7
ABS CDS	10.5	0.6	(3.3)	(5.1)
Subtotal U.S. subprime mortgage-related exposure	\$ 12.9	\$ 0.2	\$ (0.8)	\$ (1.8)
Total U.S. subprime trading exposure	\$ 7.6	\$	\$ 1.8	\$ 1.8

- (1) Statement of financial condition amounts are presented on a net asset/liability basis and do not take into account any netting of cash collateral against these positions. In addition, these amounts reflect counterparty netting to the extent that there are positions with the same counterparty that are subprime-related; they do not reflect any counterparty netting to the extent that there are positions with the same counterparty that are not subprime related. The \$7.6 billion is reflected in the Company's condensed consolidated statement of financial condition as follows: Financial instruments owned of \$15.4 billion and Financial instruments sold, not yet purchased of \$7.8 billion.
- (2) In determining the fair value of the Company's ABS super senior CDO-related exposures the Company took into consideration prices observed from the execution of a limited number of transactions and data for relevant benchmark instruments in synthetic subprime markets. Deterioration of value in the benchmark instruments as well as market developments have led to significant declines in the estimates of fair value. These declines reflected increased implied losses across this portfolio. These implied loss levels are consistent with losses in the range between 18% - 26% implied by the ABX indices. These cumulative loss levels, at a severity rate of 55%, imply defaults in the range of 52% - 61% for 2005 and 2006 outstanding mortgages.
- (3) Refers to CDOs where the collateral is comprised entirely of another CDO security.

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Subsidiary Banks.

The securities portfolios of Morgan Stanley Bank (Utah) and Morgan Stanley Trust FSB (collectively, the *Subsidiary Banks*) include certain subprime-related securities. The portfolios contain no subprime whole loans, subprime residuals or CDOs.

At February 29, 2008 and November 30, 2007, the securities portfolios totaled \$9.6 billion and \$9.9 billion, respectively, consisting primarily of AAA-rated ABS and residential mortgage-backed securities. Of these total amounts, \$4.7 billion and \$5.5 billion were subprime mortgage-related securities as of February 29, 2008 and November 30, 2007, respectively.

Non-subprime Residential Mortgages and Commercial Mortgage-backed Securities.

The Company continues to have exposure to non-subprime residential mortgages which include residential mortgage-backed securities bonds, residential Alt-A (a residential mortgage loan categorization that falls between prime and subprime) and European mortgage loans. Statement of financial condition amounts for non-subprime residential mortgages were \$14.5 billion and \$16.5 billion as of February 29, 2008 and November 30, 2007, respectively. Net exposure amounts as of February 29, 2008 and November 30, 2007 were \$8.7 billion and \$10.9 billion, respectively.

The Company also has exposure to commercial mortgage-backed securities (*CMBS*). Statement of financial condition amounts for CMBS were \$23.5 billion and \$31.5 billion as of February 29, 2008 and November 30, 2007, respectively. Net exposure amounts as of February 29, 2008 and November 30, 2007 were \$11.6 billion and \$17.5 billion, respectively.

See Note 1 to the condensed consolidated financial statements for a description regarding valuation of these instruments.

Special Purpose Entities and Variable Interest Entities.

The Company's involvement with special purpose entities (*SPEs*) and variable interest entities (*VIEs*) is discussed in Note 4 to the condensed consolidated financial statements and *Critical Accounting Policies* *Special Purpose Entities* herein. In relation to subprime loans and subprime-backed securities, the Company's involvement with SPEs/VIEs consists primarily of the following:

Engaging in securitization activities related to subprime loans and subprime-backed securities;

Acting as an underwriter of beneficial interests issued by securitization vehicles;

Transferring whole loans into SPEs/VIEs;

Holding one or more classes of securities issued by such securitization vehicles (including residual tranche securities) and possibly entering into derivative agreements with such securitization vehicles;

Purchasing and selling (in both a market-making and a proprietary-trading capacity) subprime-backed securities issued by SPEs/VIEs, whether such vehicles are sponsored by the Company or not;

Entering into derivative transactions with SPEs/VIEs (not sponsored by the Company) that hold subprime-related assets;

Providing warehouse financing to CDOs and collateralized loan obligations (*CLOs*);

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Entering into derivative agreements with non-SPEs/VIEs, whose value is derived from securities issued by SPEs/VIEs;

Servicing assets held by SPEs/VIEs or holding servicing rights related to assets held by SPEs/VIEs that are serviced by others under subservicing arrangements; and

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Serving as an asset manager to various investment funds that may invest in securities that are backed, in whole or in part, by subprime loans.

Structured Investment Vehicles.

Structured investment vehicles (SIVs) are unconsolidated entities that issue various capital notes and debt instruments to fund the purchase of assets. While the Company does not sponsor or serve as asset manager to any unconsolidated SIVs, the Company does serve as investment advisor to certain unconsolidated money market funds (the Funds) that have investments in securities issued by SIVs. In the second half of fiscal 2007, widespread illiquidity in the commercial paper market led to market value declines and rating agency downgrades of many securities issued by SIVs, some of which were held by the Funds. As a result, the Company purchased at amortized cost approximately \$900 million of such securities from the Funds during fiscal 2007 and \$217 million of such securities during the first quarter of fiscal 2008. During the first quarter of fiscal 2008, the Company recorded losses of \$187 million on these securities. The carrying value of the purchased securities still held by the Company as of February 29, 2008 was \$588 million. Such positions are reflected at fair value, and presented in Financial instruments owned Corporate and other debt in the condensed consolidated statements of financial condition. Subsequent to February 29, 2008, the Company has not purchased additional securities from the Funds. The Company has no obligation to purchase any additional securities from the Funds in the future. The Funds continue to have investments in securities issued by SIVs, with an aggregate face value of \$3.6 billion as of February 29, 2008 compared with \$8.2 billion as of November 30, 2007.

Monoline Insurers.

Monoline insurers (Monolines) provide credit enhancement to capital markets transactions. The current credit environment severely affected the capacity of such financial guarantors. The Company's direct exposure to Monolines is limited to bonds that are insured by Monolines and as counterparties to derivative contracts. The Company's direct exposure to Monolines at February 29, 2008 consisted primarily of ABS bonds of \$1.3 billion in the Subsidiary Banks' portfolio (see Subsidiary Banks) that are collateralized by first and second lien subprime mortgages enhanced by financial guarantees, \$2.6 billion in insurance municipal bond securities and \$800 million in net counterparty exposure. The Company's direct exposure to Monolines at November 30, 2007 consisted primarily of ABS bonds of \$1.5 billion in the Subsidiary Banks' portfolio, \$1.3 billion in insurance municipal bond securities and \$800 million in net counterparty exposure. The increase in direct exposure in the first quarter of fiscal 2008 reflects the Company's support for clients of the Company's municipal business, partially offset by a writedown of approximately \$600 million.

ASF Framework.

In December 2007, the American Securitization Forum (ASF) issued the Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (the ASF Framework). The overall purpose of the ASF Framework is to provide recommended guidance for servicers to streamline borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts, including refinancings, forbearances, workout plans, loan modifications, deeds-in-lieu and short sales or short payoffs. The ASF Framework is focused on subprime first-lien adjustable rate residential mortgages loans that have an initial fixed rate period of 36 months or less, are included in securitized pools, were originated between January 1, 2005 and July 31, 2007, and have an initial interest rate reset date between January 1, 2008 and July 31, 2010 (subprime ARM loans).

The ASF Framework categorizes the population of subprime ARM loans into three segments. Segment 1 includes current loans, as defined, where the borrower is likely to be able to refinance into an available mortgage product. It is expected that borrowers in this category should refinance their loans, if they are unable or unwilling to meet their reset payment. Segment 2 includes current loans where the borrower is unlikely to be able to refinance and meet specific criteria related to Fair Isaac Corporation (or FICO) scores and expected payment increase due to the initial adjustment of the interest rate. Borrowers in this segment are eligible for a fast track

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loan modification under which the interest rate will be kept at the existing rate, generally for five years following the upcoming reset. The ASF Framework indicates that for Segment 2 loans, the servicer can presume that the borrower would be unable to pay pursuant to the original terms of the loan after the interest rate reset, and thus, borrower default on the loan is reasonably foreseeable in absence of a modification. Segment 3 includes loans where the borrower is not current or which do not otherwise qualify for Segment 1 or Segment 2. For loans in this category, the servicer will determine the appropriate loss mitigation approach in a manner consistent with the applicable servicing standard in the transaction documents, but without employing the fast track procedures described under Segment 2.

In January 2008, the SEC's Office of Chief Accountant (the OCA) issued a letter (the OCA Letter) addressing accounting issues that may be raised by the ASF Framework. The OCA Letter concluded that the SEC would not object to continuing off-balance sheet accounting treatment for qualifying special purpose entities (QSPEs) that hold Segment 2 subprime ARM loans modified pursuant to the ASF Framework.

For those current loans that are accounted for off-balance sheet that are modified, but not as part of the ASF Framework above, the servicer must perform on an individual basis an analysis of the borrower and the loan to provide sufficient evidence to demonstrate that default on the loan is imminent or reasonably foreseeable.

The Company adopted the ASF Framework during the first quarter of fiscal 2008, but has not yet modified a significant volume of loans using the ASF Framework. The Company does not expect that its application of the ASF Framework will impact the off-balance sheet status of Company-sponsored QSPEs that hold Segment 2 subprime ARM loans and is currently evaluating the potential impact on its condensed consolidated statements of income. The total amount of assets owned by Company-sponsored QSPEs that hold subprime ARM loans (including those loans that are not serviced by the Company) as of February 29, 2008, was approximately \$30.5 billion. Of this amount, approximately \$11.8 billion relates to subprime ARM loans serviced by the Company. The Company's retained interests in Company sponsored QSPEs that hold subprime ARM loans totaled approximately \$272 million as of February 29, 2008.

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Other Matters.

The following matters are discussed in the Company's notes to the condensed consolidated financial statements. For further information on these matters, please see the applicable note:

	Note
Accounting Developments:	
<i>Accounting for Uncertainty in Income Taxes</i>	1
<i>Employee Benefit Plans</i>	1
<i>Offsetting of Amounts Related to Certain Contracts</i>	1
<i>Investment Company Accounting</i>	1
<i>Dividends on Share-Based Payment Awards</i>	1
<i>Business Combinations</i>	1
<i>Noncontrolling Interests</i>	1
<i>Transfers of Financial Assets and Repurchase Financing Transactions</i>	1
<i>Disclosures about Derivative Instruments and Hedging Activities</i>	1
Income Taxes	12
Discontinued Operations	14
Business Disposition	15

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Critical Accounting Policies.

The Company's condensed consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the Company to make estimates and assumptions (see Note 1 to the condensed consolidated financial statements). The Company believes that of its significant accounting policies (see Note 2 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Form 10-K), the following involve a higher degree of judgment and complexity.

Fair Value.

Financial Instruments Measured at Fair Value. A significant number of the Company's financial instruments are carried at fair value with changes in fair value recognized in earnings each period. The Company makes estimates regarding valuation of assets and liabilities measured at fair value in preparing the condensed consolidated financial statements. These assets and liabilities include:

Financial instruments owned and Financial instruments sold, not yet purchased;

Securities received as collateral and Obligation to return securities received as collateral;

Certain Commercial paper and other short-term borrowings, primarily structured notes;

Certain Deposits;

Other secured financings; and

Certain Long-term borrowings, primarily structured notes and certain junior subordinated debentures.

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. A hierarchy for inputs is used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the observable inputs be used when available. For further information on the fair value definition, Level 1, Level 2 and Level 3 hierarchy and related valuation techniques, see Note 1 to the condensed consolidated financial statements.

The Company's Level 3 assets before the impact of counterparty netting across the levels of the fair value hierarchy were \$78.2 billion and \$73.7 billion as of February 29, 2008 and November 30, 2007, respectively, and represented approximately 15% as of both periods of the assets measured at fair value (7% of total assets as of both periods). Level 3 liabilities were \$24.8 billion and \$19.5 billion as of February 29, 2008 and November 30, 2007, respectively, and represented approximately 8% and 7%, respectively, of the Company's liabilities measured at fair value.

During the quarter ended February 29, 2008, the Company reclassified approximately \$2.0 billion of certain Corporate and other debt from Level 2 to Level 3. These reclassifications included transfers primarily related to loans and loan commitments largely related to event-driven transactions. The reclassifications were due to a reduction in recently executed transactions and market price quotations for these instruments such that the inputs for these instruments became less observable.

See Note 2 to the condensed consolidated financial statements for further information about the Company's financial assets and liabilities that are accounted for at fair value.

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Fair Value Control Processes. The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach

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utilized is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks. Additionally, groups independent from the trading divisions within the Financial Control, Market Risk and Credit Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model.

Consistent with market practice, the Company has individually negotiated agreements with certain counterparties to exchange collateral (margining) based on the level of fair values of the derivative contracts they have executed. Through this margining process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional support of the Company's recorded fair value for the relevant OTC derivative products. For certain OTC derivative products, the Company, along with other market participants, contributes derivative pricing information to aggregation services that synthesize the data and make it accessible to subscribers. This information is then used to evaluate the fair value of these OTC derivative products. For more information regarding the Company's risk management practices, see Quantitative and Qualitative Disclosures about Market Risk Risk Management in Part II, Item 7A of the Form 10-K.

Legal, Regulatory and Tax Contingencies.

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.

Reserves for litigation and regulatory proceedings are generally determined on a case-by-case basis and represent an estimate of probable losses after considering, among other factors, the progress of each case, prior experience and the experience of others in similar cases, and the opinions and views of internal and external legal counsel. Given 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 matters will be resolved, when they will ultimately be resolved or what the eventual settlement, fine, penalty or other relief, if any, might be.

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

The Company establishes reserves for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated in accordance with SFAS No. 5 for

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potential losses related to litigation and regulatory proceedings and FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48) for potential losses related to tax audits. Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change. Significant judgment is required in making these estimates, and the actual cost of a legal claim, tax assessment or regulatory fine/penalty may ultimately be materially different from the recorded reserves, if any.

See Notes 8 and 12 to the condensed consolidated financial statements for additional information on legal proceedings and tax examinations.

Special Purpose Entities.

The Company enters into a variety of transactions with SPEs, primarily in connection with securitization activities. The Company engages in securitization activities related to commercial and residential mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, municipal bonds and other types of financial instruments. In most cases, these SPEs are deemed to be VIEs. Unless a VIE is determined to be a QSPE, the Company is required to perform an analysis of each VIE at the date upon which the Company becomes involved with it to determine whether the Company is the primary beneficiary of the VIE, in which case the Company must consolidate the VIE. QSPEs are not consolidated.

The Company reassesses whether it is the primary beneficiary of a VIE upon the occurrence of certain reconsideration events. If the Company's initial assessment results in a determination that it is not the primary beneficiary of a VIE, then the Company reassesses this determination upon the occurrence of:

Changes to the VIE's governing documents or contractual arrangements in a manner that reallocates the obligation to absorb the expected losses or the right to receive the expected residual returns of the VIE between the current primary beneficiary and the other variable interest holders, including the Company.

Acquisition by the Company of additional variable interests in the VIE.

If the Company's initial assessment results in a determination that it is the primary beneficiary, then the Company reassesses this determination upon the occurrence of:

Changes to the VIE's governing documents or contractual arrangements in a manner that reallocates the obligation to absorb the expected losses or the right to receive the expected residual returns of the VIE between the current primary beneficiary and the other variable interest holders, including the Company.

A sale or disposition by the Company of all or part of its variable interests in the VIE to unrelated parties.

The issuance of new variable interests by the VIE to parties unrelated to the Company.

QSPEs are not consolidated. The determination of whether an SPE meets the accounting requirements of a QSPE requires significant judgment, particularly in evaluating whether the permitted activities of the SPE are significantly limited and in determining whether derivatives held by the SPE are passive and nonexcessive. In addition, the analysis involved in determining whether an entity is a VIE, and in determining the primary beneficiary of a VIE, requires significant judgment (see Note 4 to the condensed consolidated financial statements).

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Liquidity and Capital Resources.

The Company's senior management establishes the liquidity and capital policies of the Company. Through various risk and control committees, the Company's senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity, interest rate and currency sensitivities of the Company's asset and liability position. The Company's Treasury Department and other control groups, assist in evaluating, monitoring and controlling the impact that the Company's business activities have on its condensed consolidated statements of financial condition, liquidity and capital structure.

The Balance Sheet.

The Company actively monitors and evaluates the composition and size of its balance sheet. A substantial portion of the Company's total assets consists of liquid marketable securities and short-term receivables arising principally from Institutional Securities sales and trading activities. The liquid nature of these assets provides the Company with flexibility in managing the size of its balance sheet.

The Company's total assets increased to \$1,090,896 million at February 29, 2008, from \$1,045,409 million at November 30, 2007. The increase was primarily due to increases in financial instruments owned (largely driven by increases in derivative contracts, U.S. government and agency securities, other sovereign government obligations and corporate and other debt) and securities purchased under agreements to resell, partially offset by a decrease in securities received as collateral.

Within the sales and trading related assets and liabilities are transactions attributable to securities financing activities. As of February 29, 2008, securities financing assets and liabilities were \$565 billion and \$546 billion, respectively. Securities financing transactions include repurchase and resale agreements, securities borrowed and loaned transactions, securities received as collateral and obligation to return securities received, customer receivables/payables and related segregated customer cash.

Securities financing assets and liabilities also include matched book transactions with minimal market, credit and/or liquidity risk. These matched book transactions are to accommodate customers, as well as to obtain securities for the settlement and finance of inventory positions. The customer receivable/payable portion of the securities financing transactions includes customer margin loans, collateralized by customer owned securities, and customer cash, which is segregated in order to satisfy regulatory requirements. The Company's risk exposure on these transactions is mitigated by collateral maintenance policies that limit the Company's credit exposure to customers. Included within securities financing assets was \$49 billion that, in accordance with SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS No. 140) represented equal and offsetting assets and liabilities for fully collateralized non-cash loan transactions.

Balance sheet leverage ratios are one indicator of capital adequacy when viewed in the context of a company's overall liquidity and capital policies. The Company views the adjusted leverage ratio a more relevant measure of financial risk than gross leverage when comparing financial services firms and evaluating leverage trends. The Company has adopted a definition of adjusted assets that excludes certain self-funded assets considered to have minimal market, credit and/or liquidity risk. These low-risk assets generally are attributable to the Company's matched book and securities lending businesses. Adjusted assets are calculated by reducing gross assets by aggregate resale agreements and securities borrowed less non-derivative short positions and assets recorded under certain provisions of SFAS No. 140 and FASB Interpretation No. 46 (revised December 2003) Consolidation of Variable Interest Entities (FIN 46R). Gross assets are also reduced by the full amount of cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements.

Leverage ratios reflect the deduction from shareholders' equity of the amount of equity used to support goodwill and intangible assets (as the Company does not view this amount of equity as available to support its risk capital

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needs). In addition, the Company views junior subordinated debt issued to capital trusts as a component of its capital base given the inherent characteristics of the securities. These characteristics include the long-dated nature (*e.g.*, final maturity at issuance of 30 years extendible at the Company's option by a further 19 years; others have a 60-year final maturity at issuance), the Company's ability to defer coupon interest for up to 20 consecutive quarters and the subordinated nature of the obligations in the capital structure. The Company also receives rating agency equity credit for these securities.

The following table sets forth the Company's total assets, adjusted assets and leverage ratios as of February 29, 2008 and November 30, 2007 and for the average month-end balances during the quarter ended February 29, 2008:

	Balance at		Average Month- End Balance
	February 29, 2008	November 30, 2007	For the Quarter Ended February 29, 2008
	(dollars in millions, except ratio data)		
Total assets	\$ 1,090,896	\$ 1,045,409	\$ 1,083,685
Less: Securities purchased under agreements to resell	(143,097)	(126,887)	(130,731)
Securities borrowed	(243,695)	(239,994)	(243,297)
Add: Financial instruments sold, not yet purchased	171,111	134,341	155,337
Less: Derivative contracts sold, not yet purchased	(89,392)	(71,604)	(75,666)