

Statement  
of Financial Condition

May 31, 2008 (Unaudited)

*Investments and services are offered through MS Securities Services Inc.*



MS Securities Services Inc.

**Statement of Financial Condition****(Unaudited)****(In thousands of dollars, except share data)****May 31, 2008****Assets**

Cash	\$ 868
Cash deposited with clearing organization	2,840
Financial instruments owned, at fair value:	
Corporate and other debt	154,084
Securities borrowed	164,601,531
Securities received as collateral, at fair value	434,367
Receivables from affiliate	942,001
Rebates receivable and other assets	512,955
Total assets	<u>\$166,648,646</u>

**Liabilities and Stockholders' Equity**

Securities loaned	\$163,777,641
Obligation to return securities received as collateral, at fair value	434,367
Payables to affiliates	761,054
Rebates payable and other liabilities	352,076
Total liabilities	<u>165,325,138</u>
Stockholder's equity:	
Common stock (\$1 par value, 1,000 shares authorized, issued and outstanding)	1
Paid-in capital	245,899
Retained earnings	1,077,608
Total stockholder's equity	<u>1,323,508</u>
Total liabilities and stockholder's equity	<u>\$166,648,646</u>

*See Notes to Statement of Financial Condition.*

MS Securities Services Inc.

## Notes to Statement of Financial Condition

(Unaudited)

(In thousands of dollars, except where noted)

May 31, 2008

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

MS Securities Services Inc. (the "Company") is a wholly owned subsidiary of Morgan Stanley & Co. Incorporated ("MS&Co."), which is a wholly owned subsidiary of Morgan Stanley (the "Parent"). The Company is registered with the Securities and Exchange Commission ("SEC") as a broker-dealer and is primarily engaged in the borrowing and lending of equity securities. In addition, the Company trades state and municipal government securities on a principal basis. The Company is considered a guaranteed subsidiary of MS&Co. under SEC Rule 15c3-1 (the "Net Capital Rule") and, accordingly, its excess net capital is used by MS&Co. in determining MS&Co.'s compliance with the Net Capital Rule.

**Basis of Financial Information**

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

**Related Party Transactions**

At May 31, 2008, the Company has disclosed on the statement of financial condition securities borrowed and securities loaned with affiliates of \$26,753,202 and \$159,977,982, respectively. Receivables from affiliates are primarily funds loaned overnight to MS&Co. on a collateralized basis at prevailing market rates. Payables to affiliates consists primarily of amounts due to the Parent for income taxes. Rebates receivable and other assets and rebates payable and other liabilities include securities borrowed rebates receivable and securities loaned rebates payable with affiliates of \$176,309 and \$256,130, respectively.

**NOTE 2 -****Summary of Significant Accounting Policies****Cash**

Cash consists of cash held on deposit at several financial institutions.

**Cash Deposited With Clearing Organization**

Represents cash deposited with the Options Clearing Corporation.

**Financial Instruments and Fair Value**

Financial instruments owned, which consists of state and municipal government obligations, are carried at fair value with changes in fair value recognized in earnings each period. A description of the Company's policies regarding fair value measurement and its application to these financial instruments follows.

*Financial Instruments Measured at Fair Value*

All of the instruments within Financial instruments owned 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 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.

*Fair Value Measurement — Definition and Hierarchy*

The Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS No. 157"), effective December 1, 2006. Under this standard, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date.

In determining fair value, the Company uses various valuation approaches. 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

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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 U.S. agency 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: exchange-traded equity securities and listed derivatives that are not actively traded; restricted stock; corporate and municipal bonds; certain high-yield debt and asset-backed securities.

- 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 asset-backed securities.

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.

### *Valuation Techniques*

Many cash and over-the-counter ("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 the fair value estimate always be a predetermined point in the bid-ask range. The Company's policy is to allow for mid-market pricing and 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.

### *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. Municipal 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.

### **Income Taxes**

Income taxes are provided using the asset and liability method, under which deferred tax assets and liabilities are determined based upon the temporary differences between

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the financial statement and income tax bases of assets and liabilities using currently enacted tax rates.

### Accounting Developments

In July 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109” (“FIN 48”). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the adoption of FIN 48 on December 1, 2007, the Company recorded a cumulative adjustment of approximately \$20,825 as a decrease to the opening balance of Retained earnings as of December 1, 2007.

In September 2006, the FASB issued SFAS No. 158, “Employers’ Accounting for Defined Benefit Pension Plan and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132 R” (“SFAS No. 158”). In fiscal 2007, MS&Co. adopted SFAS No. 158 requirement to recognize the overfunded or underfunded status of its defined benefit and postretirement plans as an asset or liability, which did not have an impact on the Company’s statement of financial condition. In the first quarter of fiscal 2008, the Company early adopted SFAS No. 158’s other requirements to use the fiscal year-end as the measurement date, which did not have a material impact on the Company’s statement of financial condition.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS No. 159”) which provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The Company has adopted SFAS No. 159 but not elected to apply the fair value option to any financial assets and liabilities at May 31, 2008.

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 for 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 Transfer 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 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.

### NOTE 3 -

#### Fair Value Disclosures

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

The following fair value hierarchy table presents information about the Company’s assets and liabilities measured at fair value on a recurring basis as of May 31, 2008.

#### Assets and Liabilities Measured at Fair Value on a Recurring Basis as of May 31, 2008

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance as of May 31, 2008
<b>Assets</b>				
Financial Instruments				
Owned:				
Corporate and other debt	\$ -	\$ 72,784	\$ 81,300	\$ 154,084
Securities received as collateral	434,367	-	-	434,367
<b>Liabilities</b>				
Obligation to return securities received as collateral	\$ (434,367)	\$ -	\$ -	\$ (434,367)

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

Some of the Company’s financial assets and liabilities are not measured at fair value on a recurring basis but nevertheless are recorded at amounts that approximate fair value due to their liquid or short-term nature. Such financial assets and

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financial liabilities include: cash, cash deposited with clearing organization, securities borrowed and securities loaned.

**NOTE 4 -  
Collateralized Transactions**

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

The Company enters into securities borrowed and securities loaned transactions to accommodate customers' needs. Under securities borrowed transactions, the Company receives collateral in the form of securities, which in many cases can be sold or repledged. The Company uses this collateral to enter into securities lending transactions. At May 31, 2008, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$176,331,790, of which \$176,016,957 had been repledged.

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 related obligation to return the collateral in the statement of financial condition. At May 31, 2008, \$434,367 was reported as Securities received as collateral and Obligation to return securities received as collateral in the statement of financial condition, \$381,015 of which had been repledged.

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

**NOTE 5 -  
Commitments, Guarantees and Contingencies**

The Company had \$68,450 of letters of credit outstanding at May 31, 2008 to satisfy various collateral requirements of which none was drawn down.

**NOTE 6 -  
Trading Activities****Trading**

The Company trades in fixed income securities, primarily state government and municipal securities. The counterparties to the Company's fixed income transactions include investment advisors, commercial banks, insurance companies, broker-dealers, investment funds and industrial companies.

**Risk Management**

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

The cornerstone of the Company's risk management philosophy is protection of the Company's franchise, reputation and financial standing. The Company's risk management philosophy is based on the following principles: comprehensiveness, independence, accountability, defined risk tolerance and transparency. Given the importance of effective risk management to the Company's reputation, senior management requires thorough and frequent communication and appropriate escalation of risk matters.

Risk management at the Company requires independent Company-level oversight, constant communication, judgment, and knowledge of specialized products and markets. The Company's senior management takes an active role in the identification, assessment and management of various risks of the Company. In recognition of the increasingly varied and complex nature of the financial services business, the Company's risk management philosophy, with its attendant policies, procedures and

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methodologies, is evolutionary in nature and subject to ongoing review and modification.

The nature of the Company's risks, coupled with this risk management philosophy, informs the Company's risk governance structure. The Company's risk governance structure includes the Firm Risk Committee, the Capital Structure and Strategic Transactions Committee, the Chief Risk Officer, the Internal Audit Department, independent control groups and various risk control managers, committees and groups located within and across the business units.

The Firm Risk Committee, composed of the Company's most senior officers, oversees the Company's risk management structure. The Firm Risk Committee's responsibilities include oversight of the Company's risk management principles, procedures and limits, and the monitoring of material financial, operational and franchise risks. The Firm Risk Committee is overseen by the Audit Committee of the Board of Directors (the "Audit Committee"). The Capital Structure and Strategic Transactions Committee (the "Capital Committee") reviews strategic transactions for the Company and significant changes to the Company's capital structure. The Capital Committee's responsibilities include reviewing measures of capital and evaluating capital resources relative to the Company's risk profile and strategy.

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

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

The Market Risk, Credit Risk, Operational Risk, Financial Control, Treasury, and Legal and Compliance Departments (collectively, the "Company Control Groups"), which are all independent of the Company's business units, assist senior management and the Firm Risk Committee in monitoring and controlling the Company's risk through a number of control processes. The Company is committed to employing

qualified personnel with appropriate expertise in each of its various administrative and business areas to implement effectively the Company's risk management and monitoring systems and processes.

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

### Market Risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio.

The Company manages the market risk associated with its trading activities on a Company-wide basis, on a trading division level and on an individual product basis. Aggregate market risk limits have been approved for the Company and for each major trading division. Additional market risk limits are assigned to trading desks and, as appropriate, products. Trading division risk managers, desk risk managers, traders and the Market Risk Department monitor market risk measures against limits in accordance with policies set by senior management.

The Market Risk Department independently reviews the Company's trading portfolios on a regular basis from a market risk perspective utilizing Value-at-Risk and other quantitative and qualitative risk measures and analyses. The Company's trading businesses and the Market Risk Department also use, as appropriate, measures such as sensitivity to changes in interest rates, prices, implied volatilities and time decay to monitor and report market risk exposures. Stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors for certain products, is performed periodically and is reviewed by trading division risk managers, desk risk managers and the Market Risk Department. The Market Risk Department also conducts scenario analyses, which

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estimate the Company's revenue sensitivity to a set of specific, predefined market and geopolitical events.

### Credit Risk

The Company's exposure to credit risk arises from the possibility that a customer or counterparty to a transaction might fail to perform under its contractual commitment, which could result in the Company incurring losses. The Company has credit guidelines that limit the Company's current and potential credit exposure to any one customer or counterparty and to aggregates of customers or counterparties by type of business activity. Specific credit risk limits based on these credit guidelines also are in place for each type of customer or counterparty (by rating category).

The Credit Department administers limits, monitors credit exposure, and periodically reviews the financial soundness of customers and counterparties. The Company manages the credit exposure relating to its trading activities in various ways, including entering into master netting agreements, collateral arrangements, and limiting the duration of exposure. Risk is mitigated in certain cases by closing out transactions, entering into risk reducing transactions, assigning transactions to other parties, or purchasing credit protection.

### Concentration Risk

The Company is subject to concentration risk by holding large positions in state government and municipal securities. The Company seeks to limit concentration risk through the use of systems and procedures described in the preceding discussions of risk management, market risk and credit risk.

### NOTE 7 - Income Taxes

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

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

### Income Tax Examinations

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

### Note 8 - Regulatory Requirements

The Company is a registered broker-dealer and, accordingly, is subject to the net capital rules of the SEC and the Financial Industry Regulatory Authority. Under these rules, the Company has elected to compute its net capital requirement in accordance with the "Alternative Net Capital Requirement," which specifies that net capital shall not be less than 2% of aggregate debit items arising from customer transactions or \$250, whichever is greater. At May 31, 2008, the Company's net capital, as defined under such rules, was \$1,270,630, which exceeded the minimum requirement by \$1,270,380.

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

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

### Note 9 – Subsequent Event

The Company paid a dividend totaling \$600,000 to MS&Co. as of the close of business on July 30, 2008.

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

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