

MORGAN STANLEY  
Form 10-Q  
July 07, 2006  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended May 31, 2006

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-11758

**Morgan Stanley**

(Exact Name of Registrant as Specified in its Charter)

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**Delaware**  
(State of Incorporation)

**36-3145972**  
(I.R.S. Employer Identification No.)

**1585 Broadway**

**New York, NY**  
(Address of Principal  
Executive Offices)

**10036**  
(Zip Code)

**Registrant's telephone number, including area code: (212) 761-4000**

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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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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 June 30, 2006, there were 1,071,959,235 shares of the Registrant's Common Stock, par value \$.01 per share, outstanding.

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**Table of Contents**

**MORGAN STANLEY**

**INDEX TO QUARTERLY REPORT ON FORM 10-Q**

**Quarter Ended May 31, 2006**

	<b>Page</b>
	<b>_____</b>
<b>Part I Financial Information</b>	
Item 1.	
	1
	3
	4
	5
	6
	36
Item 2.	37
Item 3.	77
Item 4.	84
<b>Part II Other Information</b>	
Item 1.	85
Item 1A.	87
Item 2.	88
Item 4.	88
Item 6.	88

**Table of Contents**

**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](http://www.sec.gov).

Morgan Stanley's internet site is [www.morganstanley.com](http://www.morganstanley.com). You can access Morgan Stanley's Investor Relations webpage through our internet site, [www.morganstanley.com](http://www.morganstanley.com), by clicking on the "About Morgan Stanley" link to the heading "Investor Relations." You can also access our Investor Relations webpage directly at [www.morganstanley.com/about/ir](http://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 our 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 Morgan Stanley's Corporate Governance webpage through our internet site, [www.morganstanley.com](http://www.morganstanley.com), by clicking on the "About Morgan Stanley" link to the heading "Inside the Company." You can also access our Corporate Governance webpage directly at [www.morganstanley.com/about/inside/governance](http://www.morganstanley.com/about/inside/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; and

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Code of Ethics and Business Conduct.

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.

ii

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

	<b>May 31, 2006</b>	<b>November 30, 2005</b>
	<b>(unaudited)</b>	
<b>Assets</b>		
Cash and cash equivalents	\$ 14,793	\$ 29,414
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements (including securities at fair value of \$26,979 at May 31, 2006 and \$30,223 at November 30, 2005)	46,612	40,130
Financial instruments owned (approximately \$104 billion and \$93 billion were pledged to various parties at May 31, 2006 and November 30, 2005, respectively):		
U.S. government and agency securities	33,781	31,742
Other sovereign government obligations	24,484	22,750
Corporate and other debt	128,358	105,381
Corporate equities	69,215	52,238
Derivative contracts	51,536	45,894
Physical commodities	2,797	2,610
	<u>310,171</u>	<u>260,615</u>
Total financial instruments owned	310,171	260,615
Securities received as collateral	61,248	43,557
Collateralized agreements:		
Securities purchased under agreements to resell	190,289	174,330
Securities borrowed	274,581	244,241
Receivables:		
Consumer loans (net of allowances of \$776 at May 31, 2006 and \$838 at November 30, 2005)	21,965	22,916
Customers	67,878	50,979
Brokers, dealers and clearing organizations	6,785	5,030
Fees, interest and other	9,328	6,137
Office facilities, at cost (less accumulated depreciation of \$3,435 at May 31, 2006 and \$3,196 at November 30, 2005)	2,809	2,733
Aircraft held for sale	2,932	3,145
Goodwill and net intangible assets	2,932	2,500
Other assets	17,652	12,796
	<u>\$ 1,027,043</u>	<u>\$ 898,523</u>
Total assets	\$ 1,027,043	\$ 898,523

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

(dollars in millions, except share data)

	May 31, 2006	November 30, 2005
	(unaudited)	
<b>Liabilities and Shareholders Equity</b>		
Commercial paper and other short-term borrowings	\$ 34,028	\$ 31,120
Deposits	22,560	18,663
Financial instruments sold, not yet purchased:		
U.S. government and agency securities	19,594	20,425
Other sovereign government obligations	29,507	25,355
Corporate and other debt	7,788	5,480
Corporate equities	52,292	45,936
Derivative contracts	48,747	44,952
Physical commodities	1,894	4,852
	<u>159,822</u>	<u>147,000</u>
Total financial instruments sold, not yet purchased	159,822	147,000
Obligation to return securities received as collateral	61,248	43,557
Collateralized financings:		
Securities sold under agreements to repurchase	257,250	237,274
Securities loaned	141,454	120,454
Other secured financings	28,798	23,534
Payables:		
Customers	131,413	112,246
Brokers, dealers and clearing organizations	6,478	4,789
Interest and dividends	5,528	3,338
Other liabilities and accrued expenses	18,158	16,835
Long-term borrowings	127,985	110,465
	<u>994,722</u>	<u>869,275</u>
Capital Units	66	66
Commitments and contingencies		
Shareholders equity:		
Common stock, \$0.01 par value;		
Shares authorized: 3,500,000,000 at May 31, 2006 and November 30, 2005;		
Shares issued: 1,211,701,552 at May 31, 2006 and November 30, 2005;		
Shares outstanding: 1,071,786,172 at May 31, 2006 and 1,057,677,994 at November 30, 2005	12	12
Paid-in capital	1,670	2,389
Retained earnings	38,125	35,185
Employee stock trust	4,726	3,060
Accumulated other comprehensive income (loss)	20	(190)
Common stock held in treasury, at cost, \$0.01 par value;		
139,915,380 shares at May 31, 2006 and 154,023,558 shares at November 30, 2005	(7,572)	(8,214)
Common stock issued to employee trust	(4,726)	(3,060)

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Total shareholders' equity	32,255	29,182
Total liabilities and shareholders' equity	\$ 1,027,043	\$ 898,523

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 May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(unaudited)		(unaudited)	
<b>Revenues:</b>				
Investment banking	\$ 1,132	\$ 814	\$ 2,114	\$ 1,635
<b>Principal transactions:</b>				
Trading	3,735	1,794	6,802	3,640
Investments	690	226	1,004	379
Commissions	1,005	824	1,934	1,648
<b>Fees:</b>				
Asset management, distribution and administration	1,333	1,246	2,612	2,450
Merchant, cardmember and other	277	318	566	626
Servicing and securitization income	651	423	1,247	917
Interest and dividends	10,114	6,035	20,663	11,878
Other	125	121	239	226
<b>Total revenues</b>	<b>19,062</b>	<b>11,801</b>	<b>37,181</b>	<b>23,399</b>
Interest expense	9,988	5,561	19,469	10,186
Provision for consumer loan losses	130	209	285	344
<b>Net revenues</b>	<b>8,944</b>	<b>6,031</b>	<b>17,427</b>	<b>12,869</b>
<b>Non-interest expenses:</b>				
Compensation and benefits	3,723	2,622	7,906	5,476
Occupancy and equipment	237	232	469	564
Brokerage, clearing and exchange fees	340	276	632	536
Information processing and communications	365	349	712	691
Marketing and business development	298	298	536	555
Professional services	538	438	972	817
Other	267	422	577	992
September 11 <sup>th</sup> related insurance recoveries, net				(251)
<b>Total non-interest expenses</b>	<b>5,768</b>	<b>4,637</b>	<b>11,804</b>	<b>9,380</b>
<b>Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net</b>				
	3,176	1,394	5,623	3,489
Losses from unconsolidated investees	103	67	172	140
Provision for income taxes	1,124	396	1,908	1,069
<b>Income from continuing operations before cumulative effect of accounting change, net</b>	<b>1,949</b>	<b>931</b>	<b>3,543</b>	<b>2,280</b>
<b>Discontinued operations:</b>				
Income/(loss) from discontinued operations	14	(5)	(42)	2
Income tax (provision)/benefit	(6)	2	17	(1)

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Income/(loss) on discontinued operations	8	(3)	(25)	1
Cumulative effect of accounting change, net				49
Net income	\$ 1,957	\$ 928	\$ 3,518	\$ 2,330
Earnings per basic share:				
Income from continuing operations	\$ 1.92	\$ 0.88	\$ 3.48	\$ 2.15
Income/(loss) on discontinued operations	0.01		(0.02)	
Cumulative effect of accounting change, net				0.05
Earnings per basic share	\$ 1.93	\$ 0.88	\$ 3.46	\$ 2.20
Earnings per diluted share:				
Income from continuing operations	\$ 1.85	\$ 0.86	\$ 3.35	\$ 2.10
Income/(loss) on discontinued operations	0.01		(0.02)	
Cumulative effect of accounting change, net				0.05
Earnings per diluted share	\$ 1.86	\$ 0.86	\$ 3.33	\$ 2.15
Average common shares outstanding:				
Basic	1,013,241,715	1,053,812,487	1,016,756,096	1,061,632,036
Diluted	1,054,733,745	1,079,811,172	1,056,493,761	1,084,988,764

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

## MORGAN STANLEY

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in millions)

	Three Months Ended		Six Months Ended	
	May 31,		May 31,	
	2006	2005	2006	2005
	(unaudited)		(unaudited)	
Net income	\$ 1,957	\$ 928	\$ 3,518	\$ 2,330
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	97	(41)	130	(45)
Net change in cash flow hedges	53	(56)	80	(50)
Comprehensive income	\$ 2,107	\$ 831	\$ 3,728	\$ 2,235

See Notes to Condensed Consolidated Financial Statements.

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

(dollars in millions)

	<b>Six Months Ended May 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(unaudited)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 3,518	\$ 2,330
Adjustments to reconcile net income to net cash used for operating activities:		
Cumulative effect of accounting change, net		(49)
Compensation payable in common stock and options	1,067	408
Depreciation and amortization	365	478
Provision for consumer loan losses	285	344
Lease adjustment		109
Insurance settlement		(251)
Aircraft-related charges	125	
Changes in assets and liabilities:		
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	(6,482)	(12,636)
Financial instruments owned, net of financial instruments sold, not yet purchased	(36,391)	(11,695)
Securities borrowed, net of securities loaned	(9,340)	(3,245)
Receivables and other assets	(23,664)	8,057
Payables and other liabilities	24,899	10,386
Securities sold under agreements to repurchase, net of securities purchased under agreements to resell	4,017	(25,023)
Net cash used for operating activities	<u>(41,601)</u>	<u>(30,787)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net proceeds from (payments for):		
Office facilities and aircraft under operating leases	1,990	(270)
Purchase of Goldfish	(1,676)	
Purchase of PULSE, net of cash acquired		(279)
Net principal disbursed on consumer loans	(6,371)	(4,813)
Sales of consumer loans	8,359	4,954
Sale of interest in POSIT		90
Insurance settlement		220
Net cash provided by (used for) investing activities	<u>2,302</u>	<u>(98)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net proceeds from (payments for):		
Short-term borrowings	2,908	3,754
Derivatives financing activities	(156)	993
Other secured financings	5,264	9,315
Deposits	3,897	2,476

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Tax benefits associated with stock-based awards	39	261
Net proceeds from:		
Issuance of common stock	229	253
Issuance of long-term borrowings	25,693	15,768
Payments for:		
Repayments of long-term borrowings	(11,306)	(6,788)
Repurchases of common stock	(1,312)	(2,276)
Cash dividends	(578)	(596)
	<u>          </u>	<u>          </u>
Net cash provided by financing activities	24,678	23,160
	<u>          </u>	<u>          </u>
Net decrease in cash and cash equivalents	(14,621)	(7,725)
Cash and cash equivalents, at beginning of period	29,414	32,811
	<u>          </u>	<u>          </u>
Cash and cash equivalents, at end of period	\$ 14,793	\$ 25,086
	<u>          </u>	<u>          </u>

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Introduction and Basis of Presentation.**

**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, Asset Management and Discover. The Company, through its subsidiaries and affiliates, provides its 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 securities and related products 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 insurance products; credit and other lending products; banking and cash management and credit solutions; retirement services; trust and fiduciary services; and engages in investment activities.

*Asset Management* provides global asset management products and services in equities, fixed income and alternative investment products through three principal distribution channels: a proprietary channel consisting of the Company's representatives; a non-proprietary channel consisting of third-party broker-dealers, banks, financial planners and other intermediaries; and the Company's institutional sales channel; and engages in investment activities.

*Discover* offers Discover®-branded credit cards and other consumer products and services, and includes the operations of Discover Network, which operates a merchant and cash access network for Discover Network branded cards, and PULSE EFT Association LP ( PULSE ), an automated teller machine/debit and electronic funds transfer network. The Discover business segment also includes consumer finance products and services in the U.K., including Morgan Stanley-branded, Goldfish-branded and various other credit cards issued on the MasterCard network.

**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, consumer loan loss levels, the outcome of litigation and tax matters, 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.

The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. The Company's policy is to consolidate all entities in which it owns more than 50% of the outstanding voting stock unless it does not control the entity. The Company also consolidates any variable interest entities for which it is deemed

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to be the primary beneficiary (see Note 11). For investments in companies in which the Company has significant influence over operating and financial decisions (generally defined as owning a voting or economic interest of 20% to 50%), the Company applies the equity method of accounting.

The Company's U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated ( MS&Co. ), Morgan Stanley & Co. International Limited ( MSIL ), Morgan Stanley Japan Securities Co., Ltd. ( MSJS ), Morgan Stanley DW Inc. ( MSDWI ), Morgan Stanley Investment Advisors Inc. and NOVUS Credit Services Inc.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation. All material intercompany balances and transactions have been eliminated.

The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2005 (the "Form 10-K"). The condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) that are, in the opinion of management, necessary for the fair statement of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

***Discontinued Operations.*** The Company's aircraft leasing business was classified as held for sale prior to its sale on March 24, 2006, and associated revenues and expenses have been reported as discontinued operations for all periods presented. Prior to being reclassified as discontinued operations, the results of the Company's aircraft leasing business were included in the Institutional Securities business segment. See Note 15 for additional information on discontinued operations.

***Revenue Recognition.***

***Investment Banking.*** Underwriting revenues and fees for 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 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 client 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, generally quarterly or annually. In certain management fee arrangements, the Company is entitled to receive performance fees when the return on assets under management exceeds certain benchmark returns or other performance targets. Performance fee revenue is accrued quarterly based on measuring account/fund performance to date versus the performance benchmark stated in the investment management agreement.

***Merchant, Cardmember and Other Fees.*** Merchant, cardmember and other fees include revenues from fees charged to merchants on credit card sales (net of interchange fees paid to banks that issue cards on the Company's merchant and cash access network), transaction fees on debit



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card transactions as well as charges to cardmembers for late payment fees, overlimit fees, balance transfer fees, credit protection fees and cash advance fees, net of cardmember rewards. Merchant, cardmember and other fees are recognized as earned. Cardmember rewards include various reward programs, including the Cashback Bonus<sup>®</sup> reward program, pursuant to which the Company pays certain cardmembers a percentage of their purchase amounts based upon a cardmember's level and type of purchases. The liability for cardmember rewards, included in Other liabilities and accrued expenses, is accrued at the time that qualified cardmember transactions occur and is calculated on an individual cardmember basis. In determining the liability for cardmember rewards, the Company considers estimated forfeitures based on historical account closure, charge-off and transaction activity. The Company records the cost of its cardmember reward programs as a reduction of Merchant, cardmember and other fees.

*Consumer Loans.* Consumer loans, which consist primarily of general purpose credit card, mortgage and consumer installment loans, are reported at their principal amounts outstanding less applicable allowances.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Interest on consumer loans is recorded to income as earned. Interest is generally accrued on credit card loans until the date of charge-off, which generally occurs at the end of the month during which an account becomes 180 days past due, except in the case of cardmember bankruptcies, probate accounts, and fraudulent transactions. Cardmember bankruptcies and probate accounts are charged off at the end of the month 60 days following the receipt of notification of the bankruptcy or death, but not later than the 180-day contractual time frame. Fraudulent transactions are reported in consumer loans at their net realizable value upon receipt of notification of the fraud through a charge to operating expenses and are subsequently written off at the end of the month 90 days following notification, but not later than the contractual 180-day time frame. The interest portion of charged-off credit card loans is written off against interest revenue. Origination costs related to the issuance of credit cards are charged to earnings over periods not exceeding 12 months.

The Company classifies a portion of its consumer loans as held for sale. Loans held for sale include the lesser of loans eligible for securitization or sale, or loans that management intends to securitize within three months, net of amortizing securitizations. These loans are carried at the lower of aggregate cost or fair value.

*Financial Instruments Used for Trading and Investment.* Financial instruments owned and Financial instruments sold, not yet purchased, which include cash and derivative products, are recorded at fair value in the condensed consolidated statements of financial condition, and gains and losses are reflected net in Principal transaction trading and investment revenues in the condensed consolidated statements of income. Loans and lending commitments associated with the Company's corporate lending activities also are primarily recorded at fair value. Fair value is the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The fair value of the Company's Financial instruments owned and Financial instruments sold, not yet purchased are generally based on observable market prices, observable market parameters or derived from such prices or parameters based on bid prices or parameters for Financial instruments owned and ask prices or parameters for Financial instruments sold, not yet purchased. In the case of financial instruments transacted on recognized exchanges, the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded. Bid prices represent the highest price a buyer is willing to pay for a financial instrument at a particular time. Ask prices represent the lowest price a seller is willing to accept for a financial instrument at a particular time.

A substantial percentage of the fair value of the Company's Financial instruments owned and Financial instruments sold, not yet purchased is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary from product to product. Where available, observable market prices and pricing parameters in a product (or a related product) may be used to derive a price without requiring significant judgment. In certain markets, observable market prices or market parameters are not available for all products, and fair value is determined using techniques appropriate for each particular product. These techniques involve some degree of judgment. The price transparency of the particular product will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of product, whether it is a new product and not yet established in the marketplace, and the characteristics particular to the transaction. Products for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, products that are thinly traded or not quoted will generally have reduced to no price transparency.

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The fair value of over-the-counter ( OTC ) derivative contracts is derived primarily using pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. In the absence of observable market prices or parameters in an active market, observable prices or parameters of other comparable current market transactions, or other observable data supporting a fair value based on a pricing model at the inception of a contract, fair value is based on the transaction price. The Company also uses pricing models to manage the risks introduced by OTC derivatives. 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, simulation models or a combination thereof, applied consistently. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

Purchases and sales of financial instruments and related expenses are recorded in the accounts on trade date. Unrealized gains and losses arising from the Company's dealings in OTC financial instruments, including derivative contracts related to financial instruments and commodities, are presented in the accompanying condensed consolidated statements of financial condition on a net-by-counterparty basis, when appropriate.

The Company nets cash collateral paid or received against its derivatives inventory under credit support annexes, which the Company views as conditional contracts, to legally enforceable master netting agreements.

Equity and debt securities purchased in connection with private equity and other principal investment activities initially are carried in the condensed consolidated financial statements at their original costs, which approximate fair value. The carrying value of such securities is adjusted when changes in the underlying fair values are readily ascertainable, generally as evidenced by observable market prices or transactions that directly affect the value of such securities. Downward adjustments relating to such securities are made in the event that the Company determines that the fair value is less than the carrying value. The Company's partnership interests, including general partnership and limited partnership interests in real estate funds, are included within Other assets in the condensed consolidated statements of financial condition and are recorded at fair value based upon changes in the fair value of the underlying partnership's net assets.

*Financial Instruments Used for Asset and Liability Management.* The Company enters into various derivative financial instruments for non-trading purposes. These instruments are included within Financial instruments owned derivative contracts or Financial instruments sold, not yet purchased derivative contracts within the condensed consolidated statements of financial condition and include interest rate swaps, foreign currency swaps, equity swaps and foreign exchange forwards. The Company uses interest rate and currency swaps and equity derivatives to manage interest rate, currency and equity price risk arising from certain liabilities. The Company also utilizes interest rate swaps to match the repricing characteristics of consumer loans with those of the borrowings that fund these loans. Certain of these derivative financial instruments are designated and qualify as fair value hedges, which hedge the changes in fair value of assets, liabilities or firm commitments and cash flow hedges, which hedge the variability of future cash flows from forecasted transactions and floating rate assets and liabilities.

The Company's designated fair value hedges consist primarily of hedges of fixed rate borrowings, including fixed rate borrowings that fund consumer loans.

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For qualifying fair value hedges, the changes in the fair value of the derivative and the gain or loss on the hedged asset or liability relating to the risk being hedged are recorded currently in earnings. These amounts are recorded in Interest expense and provide offset of one another. For qualifying cash flow hedges, the changes in the fair

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

value of the derivative are recorded in Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, and amounts in Accumulated other comprehensive income (loss) are reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Ineffectiveness relating to fair value and cash flow hedges, if any, is recorded within Interest expense. The impact of hedge ineffectiveness on the condensed consolidated statements of income was not material for all periods presented.

In connection with the sale of the aircraft financing business (see Note 15), 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, which were designated as hedges of the Company's variable rate long-term borrowings, are being reclassified to earnings when the hedged forecasted transactions impact earnings, as these transactions are still probable of occurring.

The Company also utilizes foreign exchange forward contracts to manage the currency exposure relating to its net monetary investments in non-U.S. dollar functional currency operations. The gain or loss from revaluing these contracts is deferred and reported within Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, with the related unrealized amounts due from or to counterparties included in Financial instruments owned or Financial instruments sold, not yet purchased. The interest elements (forward points) on these foreign exchange forward contracts are recorded in earnings.

*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, credit card loans and other types of financial assets (see Notes 3 and 4). The Company may retain interests in the securitized financial assets as one or more tranches of the securitization, undivided seller's interests, accrued interest receivable subordinate to investors' interests (see Note 4), cash collateral accounts, servicing rights, rights to any excess cash flows remaining after payments to investors in the securitization trusts of their contractual rate of return and reimbursement of credit losses, and other retained interests. The exposure to credit losses from securitized loans is limited to the Company's retained contingent risk, which represents the Company's retained interest in securitized loans, including any credit enhancement provided. The gain or loss on the sale of financial assets depends in part on the previous carrying amount of the assets involved in the transfer, and each subsequent transfer in revolving structures, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. To obtain fair values, observable market prices are used if available. However, observable market prices are generally not available for 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, payment rates, forward yield curves and discount rates commensurate with the risks involved. The present value of future net excess cash flows that the Company estimates it will receive over the term of the securitized loans is recognized in income as the loans are securitized. A corresponding asset also is recorded and charged to income over the term of the securitized loans, with actual net excess cash flows continuing to be recognized in income as they are earned.

*Stock-Based Compensation.* The Company early adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment, using the modified prospective approach as of December 1, 2004. SFAS No. 123R revised the fair value-based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarified guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to service periods. Upon adoption, the Company recognized an \$80 million gain (\$49 million after-tax) as a cumulative effect of a change in accounting principle in the first quarter of fiscal 2005 resulting from the requirement to estimate forfeitures at the date of grant instead of recognizing them as incurred. The cumulative effect gain increased both basic and diluted earnings per share by \$0.05.



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For stock-based awards issued prior to the adoption of SFAS No. 123R, the Company's accounting policy for awards granted to retirement-eligible employees was to recognize compensation cost over the service period specified in the award terms. The Company accelerates any unrecognized compensation cost for such awards if and when a retirement-eligible employee leaves the Company. For stock-based awards made to retirement-eligible employees during fiscal 2005, the Company recognized compensation expense for such awards on the date of grant.

For fiscal 2005 year-end stock-based compensation awards that were granted to retirement-eligible employees in December 2005, the Company recognized the compensation cost for such awards at the date of grant instead of over the service period specified in the award terms. As a result, the Company recorded non-cash incremental compensation expenses of approximately \$395 million in the first quarter of fiscal 2006 for stock-based awards granted to retirement-eligible employees as part of the fiscal 2005 year-end award process and for awards granted to retirement-eligible employees, including new hires, in the first quarter of fiscal 2006. These incremental expenses were included within Compensation and benefits expense and reduced income before taxes within the Institutional Securities (\$270 million), Global Wealth Management Group (\$80 million), Asset Management (\$28 million) and Discover (\$17 million) business segments.

Additionally, based on interpretive guidance related to SFAS No. 123R in the first quarter of fiscal 2006, the Company changed its accounting policy for expensing the cost of anticipated fiscal 2006 year-end equity awards that will be granted to retirement-eligible employees in the first quarter of fiscal 2007. Effective December 1, 2005, the Company accrues the estimated cost of these awards over the course of the current fiscal year rather than expensing the awards on the date of grant (currently scheduled to occur in December 2006). The Company believes that this method of recognition for retirement-eligible employees is preferable because it better reflects the period over which the compensation is earned.

If the Company had accrued the estimated cost of equity awards granted to retirement-eligible employees over the course of the fiscal year ended November 30, 2005 rather than expensing such awards at the grant date in December 2005, net income would have decreased for the quarter and six month period ended May 31, 2005. The approximate resulting pro forma net income would have been \$860 million and \$2,198 million, respectively, rather than the reported amounts of \$928 million and \$2,330 million, respectively. The approximate resulting impact on earnings per share for the quarter ended May 31, 2005 would have been a reduction in the reported amounts of earnings per basic share from \$0.88 to \$0.82 and earnings per diluted share from \$0.86 to \$0.80. The approximate resulting impact on earnings per share for the six month period ended May 31, 2005 would have been a reduction in the reported amounts of earnings per basic share from \$2.20 to \$2.07 and earnings per diluted share from \$2.15 to \$2.03.

**2. Goodwill and Intangible Assets.**

During the first quarter of fiscal 2006, the Company completed the annual goodwill impairment test (as of December 1 in each fiscal year). The Company's testing did not indicate any goodwill impairment.



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

Changes in the carrying amount of the Company's goodwill and intangible assets for the six month period ended May 31, 2006 were as follows:

	Institutional Securities	Global Wealth Management Group	Asset Management	Discover	Total
	(dollars in millions)				
<b>Goodwill:</b>					
<b>Balance as of November 30, 2005</b>	\$ 444	\$ 540	\$ 966	\$ 256	\$ 2,206
Translation adjustments		30		16	46
Goodwill acquired during the period(1)	2		2	232	236
<b>Balance as of May 31, 2006</b>	<b>\$ 446</b>	<b>\$ 570</b>	<b>\$ 968</b>	<b>\$ 504</b>	<b>\$ 2,488</b>
<b>Intangible assets:</b>					
<b>Balance as of November 30, 2005</b>	\$ 227	\$	\$	\$ 67	\$ 294
Intangible assets acquired during the period(1)	26		4	128	158
Translation adjustments				10	10
Amortization expense	(13)			(5)	(18)
<b>Balance as of May 31, 2006</b>	<b>\$ 240</b>	<b>\$</b>	<b>\$ 4</b>	<b>\$ 200</b>	<b>\$ 444</b>

(1) Discover activity represents goodwill and intangible assets acquired in connection with the Company's acquisition of Goldfish (see Note 16).

**3. Collateralized and Securitization 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 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) on 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	At
	May 31, 2006	November 30, 2005
	(dollars in millions)	
Financial instruments owned:		
U.S. government and agency securities	\$ 13,519	\$ 12,494
Other sovereign government obligations	155	328
Corporate and other debt	35,387	21,775
Corporate equities	5,837	5,290
	<hr/>	<hr/>
Total	\$ 54,898	\$ 39,887
	<hr/>	<hr/>

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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 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 transactions or for delivery to counterparties to cover short positions. At May 31, 2006 and November 30, 2005, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$909 billion and \$798 billion, respectively, and the fair value of the portion that has been sold or repledged was \$801 billion and \$737 billion, 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.

In connection with its Institutional Securities business, the Company engages in securitization activities related to residential and commercial mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, and other types of financial assets. These assets are carried at fair value, 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. Retained interests in securitized financial assets associated with the Institutional Securities business were approximately \$3.7 billion at May 31, 2006, the majority of which were related to residential mortgage loan, U.S. agency collateralized mortgage obligation and commercial mortgage loan securitization transactions. Net gains at the time of securitization were not material in the six month period ended May 31, 2006. The assumptions that the Company used to determine the fair value of its retained interests at the time of securitization related to those transactions that occurred during the quarter and six month period ended May 31, 2006 were not materially different from the assumptions included in the table below. Additionally, as indicated in the table below, the Company's exposure to credit losses related to these retained interests was not material to the Company's results of operations.

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

The following table presents information on the Company's residential mortgage loan, U.S. agency collateralized mortgage obligation and commercial mortgage loan 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 May 31, 2006 were as follows (dollars in millions):

	<b>Residential</b>	<b>U.S. Agency</b>	
	<b>Mortgage</b>	<b>Collateralized</b>	<b>Commercial</b>
	<b>Loans</b>	<b>Mortgage</b>	<b>Mortgage</b>
	<b>Loans</b>	<b>Obligations</b>	<b>Loans</b>
Retained interests (carrying amount/fair value)	\$ 2,594	\$ 865	\$ 173
Weighted average life (in months)	38	113	60
Credit losses (rate per annum)	0.00-4.25%		0.00-5.06%
Impact on fair value of 10% adverse change	\$ (92)	\$	\$ (1)
Impact on fair value of 20% adverse change	\$ (174)	\$	\$ (2)
Weighted average discount rate (rate per annum)	9.00%	6.26%	8.10%
Impact on fair value of 10% adverse change	\$ (44)	\$ (29)	\$ (4)
Impact on fair value of 20% adverse change	\$ (88)	\$ (56)	\$ (7)
Prepayment speed assumption(1)(2)	318-2833PSA	131-242PSA	
Impact on fair value of 10% adverse change	\$ (43)	\$ (4)	\$
Impact on fair value of 20% adverse change	\$ (50)	\$ (7)	\$

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

(2) 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 table above does 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 independent 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.

In connection with its Institutional Securities business, during the six month periods ended May 31, 2006 and 2005, the Company received proceeds from new securitization transactions of \$31.0 billion and \$34.5 billion, respectively, and cash flows from retained interests in securitization transactions of \$2,843 million and \$3,655 million, respectively.

**4. Consumer Loans.**

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Consumer loans were as follows:

	At May 31, 2006	At November 30, 2005
	(dollars in millions)	
General purpose credit card, mortgage and consumer installment	\$ 22,741	\$ 23,754
Less:		
Allowance for consumer loan losses	776	838
Consumer loans, net	\$ 21,965	\$ 22,916

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

Activity in the allowance for consumer loan losses was as follows:

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005(1)	2006	2005(1)
	(dollars in millions)			
Balance at beginning of period	\$ 785	\$ 854	\$ 838	\$ 943
Additions:				
Provision for consumer loan losses	130	209	285	344
Purchase of consumer loans(2)	9		53	
Deductions:				
Charge-offs	(192)	(261)	(492)	(521)
Recoveries	42	40	89	76
Net charge-offs	(150)	(221)	(403)	(445)
Translation adjustments and other	2	(2)	3	(2)
Balance at end of period	\$ 776	\$ 840	\$ 776	\$ 840

(1) Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation.

(2) Amounts relate to the Company's acquisition of Goldfish (see Note 16).

Information on net charge-offs of interest and cardmember fees was as follows:

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(dollars in millions)			
Interest accrued on general purpose credit card loans subsequently charged off, net of recoveries (recorded as a reduction of Interest revenue)	\$ 44	\$ 50	\$ 82	\$ 106
Cardmember fees accrued on general purpose credit card loans subsequently charged off, net of recoveries (recorded as a reduction to Merchant, cardmember and other fee revenue)	\$ 23	\$ 27	\$ 45	\$ 60

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At May 31, 2006, the Company had commitments to extend credit for consumer loans of approximately \$273 billion. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards, provided there is no violation of conditions established in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness.

At May 31, 2006 and November 30, 2005, \$874 million and \$4,080 million, respectively, of the Company's consumer loans were classified as held for sale.

The Company received net proceeds from consumer loan sales of \$1,349 million and \$8,359 million in the quarter and six month period ended May 31, 2006 and \$262 million and \$4,954 million in the quarter and six month period ended May 31, 2005.

***Credit Card Securitization Activities.*** The Company's retained interests in credit card asset securitizations include undivided seller's interests, accrued interest receivable on securitized credit card receivables, cash collateral accounts, servicing rights, rights to any excess cash flows ( Residual Interests ) remaining after

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

payments to investors in the securitization trusts of their contractual rate of return and reimbursement of credit losses, and other retained interests. The undivided seller's interests less an applicable allowance for loan losses is recorded in Consumer loans. The Company's undivided seller's interests rank *pari passu* with investors' interests in the securitization trusts, and the remaining retained interests are subordinate to investors' interests. Accrued interest receivable and certain other subordinated retained interests are recorded in Other assets at amounts that approximate fair value. The Company receives annual servicing fees of 2% of the investor principal balance outstanding. The Company does not recognize servicing assets or servicing liabilities for servicing rights since the servicing contracts provide just adequate compensation (as defined in SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities) to the Company for performing the servicing. Residual Interests and cash collateral accounts are recorded in Other assets and reflected at fair value with changes in fair value recorded currently in earnings. At May 31, 2006, the Company had \$10,255 million of retained interests, including \$6,869 million of undivided seller's interests, in credit card asset securitizations. The retained interests are subject to credit, payment and interest rate risks on the transferred credit card assets. The investors and the securitization trusts have no recourse to the Company's other assets for failure of cardmembers to pay when due.

During the six month periods ended May 31, 2006 and 2005, the Company completed credit card asset securitizations of \$6.6 billion and \$3.4 billion, respectively, and recognized net securitization gains of \$156 million and \$16 million, respectively, as servicing and securitization income in the condensed consolidated statements of income. The amount for the six month period ended May 31, 2006 includes an increase in the fair value of the Company's retained interests in securitized credit card receivables primarily resulting from a favorable impact on charge-offs following the enactment of federal bankruptcy legislation that became effective in October 2005. The uncollected balances of securitized general purpose credit card loans were \$26.8 billion and \$24.4 billion at May 31, 2006 and November 30, 2005, respectively.

Key economic assumptions used in measuring the Residual Interests at the date of securitization resulting from credit card asset securitizations completed during the six month periods ended May 31, 2006 and 2005 were as follows:

	Six Months Ended May 31,	
	2006	2005
Weighted average life (in months)	3.7 - 4.7	5.9
Payment rate (rate per month)	19.69% - 21.34%	18.52%
Credit losses (rate per annum)	4.72% - 5.23%	6.00%
Discount rate (rate per annum)	11.00%	12.00%



Table of Contents

## MORGAN STANLEY

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Key economic assumptions and the sensitivity of the current fair value of the Residual Interests to immediate 10% and 20% adverse changes in those assumptions were as follows (dollars in millions):

	At
	May 31,
	2006
	<u>          </u>
Residual Interests (carrying amount/fair value)	\$ 338
Weighted average life (in months)	4.3
Weighted average payment rate (rate per month)	21.58%
Impact on fair value of 10% adverse change	\$ (25)
Impact on fair value of 20% adverse change	\$ (46)
Weighted average credit losses (rate per annum)	4.46%
Impact on fair value of 10% adverse change	\$ (39)
Impact on fair value of 20% adverse change	\$ (78)
Weighted average discount rate (rate per annum)	11.00%
Impact on fair value of 10% adverse change	\$ (1)
Impact on fair value of 20% adverse change	\$ (3)

The sensitivity analysis in the table above 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 Residual Interests is calculated independent of changes in any other assumption; in practice, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower payments and increased credit losses), 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.

The table below summarizes certain cash flows received from the securitization master trusts (dollars in billions):

	Six Months Ended	
	May 31,	
	2006	2005
	<u>          </u>	<u>          </u>
Proceeds from new credit card asset securitizations	\$ 6.6	\$ 3.4
Proceeds from collections reinvested in previous credit card asset securitizations	\$ 29.6	\$ 29.1
Contractual servicing fees received	\$ 0.3	\$ 0.3

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Cash flows received from retained interests

\$ 1.1 \$ 1.0

The table below presents quantitative information about delinquencies, net principal credit losses and components of managed general purpose credit card loans, including securitized loans (dollars in millions):

	At May 31, 2006		Six Months Ended May 31, 2006	
	Loans Outstanding	Loans Delinquent	Average Loans	Net Principal Credit Losses
Managed general purpose credit card loans	\$ 48,539	\$ 1,599	\$ 47,439	\$ 992
Less: Securitized general purpose credit card loans	26,775			
Owned general purpose credit card loans	\$ 21,764			

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**5. Long-Term Borrowings.**

Long-term borrowings at May 31, 2006 scheduled to mature within one year aggregated \$14,631 million.

During the six month period ended May 31, 2006, the Company issued senior notes aggregating \$26,454 million, including non-U.S. dollar currency notes aggregating \$11,530 million and \$889 million of junior subordinated debentures. Maturities in the aggregate of these notes by fiscal year are as follows: 2006, \$3 million; 2007, \$2,501 million; 2008, \$5,351 million; 2009, \$3,308 million; 2010, \$1,012 million; and thereafter, \$14,279 million. In the six month period ended May 31, 2006, \$11,306 million of senior notes were repaid.

The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately five years at May 31, 2006.

**6. Shareholders Equity.**

**Regulatory Requirements.** MS&Co. and MSDWI are registered broker-dealers and registered futures commission merchants and, accordingly, are subject to the minimum net capital requirements of the Securities and Exchange Commission (the "SEC"), the New York Stock Exchange, Inc. (the "NYSE") and the Commodity Futures Trading Commission. MS&Co. and MSDWI have consistently operated in excess of these requirements. MS&Co.'s net capital totaled \$4,762 million at May 31, 2006, which exceeded the amount required by \$3,721 million. MSDWI's net capital totaled \$1,210 million at May 31, 2006, which exceeded the amount required by \$1,136 million. MSIL, 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. MSIL and MSJS have 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 5% 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 May 31, 2006, 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., the Company's triple-A rated derivative products subsidiary, maintains certain operating restrictions that have been reviewed by various rating agencies.

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Effective December 1, 2005, the Company became 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 May 31, 2006, 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 May 31, 2006, MS&Co. had tentative net capital in excess of the minimum and the notification requirements.

**Treasury Shares.** During the six month period ended May 31, 2006, the Company purchased approximately \$1,312 million of its common stock through open market purchases at an average cost of \$59.47 per share.

Table of Contents

## MORGAN STANLEY

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the six month period ended May 31, 2005, the Company purchased approximately \$2,276 million of its common stock through a combination of open market purchases and employee purchases at an average cost of \$55.13 per share.

**7. Earnings per Share.**

Basic 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		Six Months Ended	
	May 31,		May 31,	
	2006	2005	2006	2005
<b>Basic EPS:</b>				
Income from continuing operations before cumulative effect of accounting change, net	\$ 1,949	\$ 931	\$ 3,543	\$ 2,280
Income/(loss) on discontinued operations	8	(3)	(25)	1
Cumulative effect of accounting change, net				49
Net income applicable to common shareholders	\$ 1,957	\$ 928	\$ 3,518	\$ 2,330
Weighted average common shares outstanding	1,013	1,054	1,017	1,062
Earnings per basic share:				
Income from continuing operations	\$ 1.92	\$ 0.88	\$ 3.48	\$ 2.15
Income/(loss) on discontinued operations	0.01		(0.02)	
Cumulative effect of accounting change, net				0.05
Earnings per basic share	\$ 1.93	\$ 0.88	\$ 3.46	\$ 2.20
<b>Diluted EPS:</b>				
Net income applicable to common shareholders	\$ 1,957	\$ 928	\$ 3,518	\$ 2,330
Weighted average common shares outstanding	1,013	1,054	1,017	1,062
Effect of dilutive securities:				
Stock options and restricted stock units	42	26	39	23
Weighted average common shares outstanding and common stock equivalents	1,055	1,080	1,056	1,085

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Earnings per diluted share:				
Income from continuing operations	\$ 1.85	\$ 0.86	\$ 3.35	\$ 2.10
Income/(loss) on discontinued operations	0.01		(0.02)	
Cumulative effect of accounting change, net				0.05
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>
Earnings per diluted share	\$ 1.86	\$ 0.86	\$ 3.33	\$ 2.15
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>

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

	Three Months Ended		Six Months Ended	
	May 31,		May 31,	
	2006	2005	2006	2005
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>
	(shares in millions)			
Number of antidilutive securities (including stock options and restricted stock units) outstanding at end of period	40	97	42	96

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

Cash dividends declared per common share were \$0.27 and \$0.54 for the quarters and six month periods ended May 31, 2006 and 2005.

**8. Commitments and Contingencies.**

**Letters of Credit.** At May 31, 2006 and November 30, 2005, the Company had approximately \$7,585 million and \$6,904 million, respectively, of letters of credit outstanding to satisfy various collateral requirements.

**Securities Activities.** In connection with certain of its Institutional Securities business activities, the Company provides loans or lending commitments (including bridge financing) to selected clients. The borrowers may be rated investment grade or non-investment grade. These loans and commitments have varying terms, may be senior or subordinated, are generally contingent upon representations, warranties and contractual conditions applicable to the borrower, and may be syndicated or traded by the Company.

The aggregate value of the investment grade and non-investment grade lending commitments are shown below:

	At	At
	May 31,	November 30,
	2006	2005
	(dollars in millions)	
Investment grade lending commitments	\$ 27,088	\$ 23,968
Non-investment grade lending commitments	8,189	13,066
<b>Total</b>	<b>\$ 35,277</b>	<b>\$ 37,034</b>

Financial instruments sold, not yet purchased include obligations of the Company to deliver specified financial instruments at contracted prices, thereby creating commitments to purchase the financial instruments in the market at prevailing prices. Consequently, the Company's ultimate obligation to satisfy the sale of financial instruments sold, not yet purchased may exceed the amounts recognized in the condensed consolidated statements of financial condition.

The Company has commitments to fund other less liquid investments, including at May 31, 2006, \$496 million in connection with investment activities, \$13,593 million related to secured lending transactions and \$8,550 million related to forward purchase contracts involving mortgage loans. Additionally, the Company has provided and will continue to provide financing, including margin lending and other extensions of credit,

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to clients that may subject the Company to increased credit and liquidity risks.

At May 31, 2006, the Company had commitments to enter into reverse repurchase and repurchase agreements of approximately \$106 billion and \$82 billion, respectively.

**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 number of reviews, investigations and proceedings has increased in recent years.



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

The Company contests liability and/or the amount of damages in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how such 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, and except for the pending matters described in the paragraphs below, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of the pending matters will not have a material adverse effect on the condensed consolidated financial condition of the Company, although the outcome of such matters could be material to the Company's operating results 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. Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

**Coleman Litigation.** On May 8, 2003, Coleman (Parent) Holdings Inc. (CPH) filed a complaint against the Company in the Circuit Court of the Fifteenth Judicial Circuit for Palm Beach County. The complaint relates to the merger between The Coleman Company, Inc. (Coleman) and Sunbeam, Inc. (Sunbeam) in 1998. The complaint, as amended, alleges that CPH was induced to agree to the transaction with Sunbeam based on certain financial misrepresentations, and it asserts claims against the Company for aiding and abetting fraud, conspiracy and punitive damages. Shortly before trial, which commenced in April 2005, the trial court granted, in part, a motion for entry of a default judgment against the Company and ordered that portions of CPH's complaint, including those setting forth CPH's primary allegations against the Company, be read to the jury and deemed established for all purposes in the action. In May 2005, the jury returned a verdict in favor of CPH and awarded CPH \$604 million in compensatory damages and \$850 million in punitive damages. On June 23, 2005, the trial court issued a final judgment in favor of CPH in the amount of \$1,578 million, which includes prejudgment interest and excludes certain payments received by CPH in settlement of related claims against others. On June 27, 2005, the Company filed a notice of appeal with the District Court of Appeal for the Fourth District of Florida and posted a supersedeas bond, which automatically stayed execution of the judgment pending appeal. Included in Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements in the condensed consolidated statement of financial condition is \$1,863 million of commercial paper and other securities which have been pledged to obtain the bond which was posted in this matter. The Company filed its initial brief in support of its appeal on December 7, 2005. The Company's appeal seeks to reverse the judgment of the trial court on several grounds and asks that the case be remanded for entry of a judgment in favor of the Company or, in the alternative, for a new trial. On June 28, 2006, the District Court of Appeal for the Fourth District of Florida heard oral argument on the Company's appeal from the judgment of the trial court.

The Company believes, after consultation with outside counsel, that it is probable that the compensatory and punitive damages awards will be overturned on appeal and the case remanded for a new trial. Taking into account the advice of outside counsel, the Company is maintaining a reserve of \$360 million for the Coleman litigation, which it believes to be a reasonable estimate, under SFAS No. 5, of the low end of the range of its probable exposure in the event the judgment is overturned and the case remanded for a new trial. If the compensatory and/or punitive awards are ultimately upheld on appeal, in whole or in part, the Company may incur an additional expense equal to the difference between the amount affirmed on appeal (and post-judgment interest thereon) and the amount of the reserve. While the Company cannot predict with certainty the amount of such additional expense, such additional expense could have a material adverse effect on the condensed consolidated financial condition of the Company and/or the Company's or Institutional Securities operating results for a particular future period, and the upper end of the range could exceed \$1.2 billion.

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***IPO Allocation Matters.*** In connection with the Company's role as either lead or co-lead underwriter in several initial public offerings ( IPO ), the Company has been exposed to both regulatory and civil proceedings. On January 25, 2005, the Company announced a settlement with the SEC regarding allegations that it violated Rule 101 of Regulation M by attempting to induce certain customers that received shares in IPOs to place purchase orders for additional shares in the aftermarket. Under the terms of the settlement, the Company agreed, without admitting or denying the allegations, to the entry of a judgment enjoining it from violating Rule 101 of Regulation M and the payment of a \$40 million civil penalty. The court approved the settlement on February 4, 2005.

In addition to the above mentioned regulatory matter with the SEC, numerous purported class actions have been filed against certain issuers of IPO securities, certain individual officers of those issuers, the Company and other underwriters of those IPOs, purportedly on behalf of purchasers of stock in the IPOs or the aftermarket. These complaints allege that the Company required customers that wanted allocations of hot IPO securities to pay undisclosed and excessive underwriters' compensation in the form of increased brokerage commissions and to buy shares of securities offered in the IPOs after the IPOs were completed at escalating price levels higher than the IPO price (a practice plaintiffs refer to as laddering ). Some of the complaints also allege that continuous buy recommendations by the defendants' research analysts improperly increased or sustained the prices at which the securities traded after the IPOs.

***Income Taxes.*** For information on contingencies associated with income tax examinations, see Note 17.

**9. Derivative Contracts.**

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 11 to the consolidated financial statements for the fiscal year ended November 30, 2005, included in the Form 10-K.

The fair value (carrying amount) of derivative instruments represents the amount at which the derivative could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale, and is further described in Note 1. 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.

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

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the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary. The Company believes the ultimate settlement of the transactions outstanding at May 31, 2006 will not have a material effect on the Company's financial condition.

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

The Company's derivatives (both listed and OTC) at May 31, 2006 and November 30, 2005 are summarized in the table below, showing the fair value of the related assets and liabilities by product:

<b>Product Type</b>	<b>At May 31, 2006</b>		<b>At November 30, 2005</b>	
	<b>Assets</b>	<b>Liabilities</b>	<b>Assets</b>	<b>Liabilities</b>
	(dollars in millions)			
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts	\$ 18,661	\$ 11,838	\$ 17,157	\$ 13,212
Foreign exchange forward contracts and options	8,034	8,053	7,548	7,597
Equity securities contracts (including equity swaps, warrants and options)	10,393	15,793	7,290	11,957
Commodity forwards, options and swaps	14,448	13,063	13,899	12,186
<b>Total</b>	<b>\$ 51,536</b>	<b>\$ 48,747</b>	<b>\$ 45,894</b>	<b>\$ 44,952</b>

**10. 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, Asset Management and Discover. For further discussion of the Company's business segments, see Note 1. Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation.

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 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)**

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

<b>Three Months Ended May 31, 2006</b>	<b>Institutional Securities(1)</b>	<b>Global Wealth Management Group</b>	<b>Asset Management</b>	<b>Discover</b>	<b>Intersegment Eliminations(1)</b>	<b>Total</b>
			(dollars in millions)			
Net revenues excluding net interest	\$ 6,119	\$ 1,272	\$ 718	\$ 803	\$ (94)	\$ 8,818
Net interest	(393)	130	5	388	(4)	126
<b>Net revenues</b>	<b>\$ 5,726</b>	<b>\$ 1,402</b>	<b>\$ 723</b>	<b>\$ 1,191</b>	<b>\$ (98)</b>	<b>\$ 8,944</b>
Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net	\$ 2,267	\$ 157	\$ 224	\$ 541	\$ (13)	\$ 3,176
Losses from unconsolidated investees	103					103
Provision for income taxes	786	51	89	203	(5)	1,124
<b>Income from continuing operations before cumulative effect of accounting change, net(2)</b>	<b>\$ 1,378</b>	<b>\$ 106</b>	<b>\$ 135</b>	<b>\$ 338</b>	<b>\$ (8)</b>	<b>\$ 1,949</b>
<b>Three Months Ended May 31, 2005(3)</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management</b>	<b>Discover</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
			(dollars in millions)			
Net revenues excluding net interest	\$ 3,300	\$ 1,149	\$ 641	\$ 534	\$ (67)	\$ 5,557
Net interest	40	79	1	354		474
<b>Net revenues</b>	<b>\$ 3,340</b>	<b>\$ 1,228</b>	<b>\$ 642</b>	<b>\$ 888</b>	<b>\$ (67)</b>	<b>\$ 6,031</b>
Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net	\$ 813	\$ 118	\$ 175	\$ 263	\$ 25	\$ 1,394
Losses from unconsolidated investees	67					67
Provision for income taxes	171	48	68	99	10	396
<b>Income from continuing operations before cumulative effect of accounting change, net(2)</b>	<b>\$ 575</b>	<b>\$ 70</b>	<b>\$ 107</b>	<b>\$ 164</b>	<b>\$ 15</b>	<b>\$ 931</b>



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

Six Months Ended May 31, 2006	Institutional	Global Wealth Management	Asset	Discover	Intersegment	Total
	Securities(1)	Group	Management		Eliminations(1)	
	(dollars in millions)					
Net revenues excluding net interest	\$ 10,983	\$ 2,467	\$ 1,412	\$ 1,537	\$ (166)	\$ 16,233
Net interest	217	219	6	743	9	1,194
<b>Net revenues</b>	<b>\$ 11,200</b>	<b>\$ 2,686</b>	<b>\$ 1,418</b>	<b>\$ 2,280</b>	<b>\$ (157)</b>	<b>\$ 17,427</b>
Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net	\$ 4,021	\$ 180	\$ 396	\$ 1,020	\$ 6	\$ 5,623
Losses from unconsolidated investees	171			1		172
Provision for income taxes	1,309	60	156	381	2	1,908
<b>Income from continuing operations before cumulative effect of accounting change, net(2)</b>	<b>\$ 2,541</b>	<b>\$ 120</b>	<b>\$ 240</b>	<b>\$ 638</b>	<b>\$ 4</b>	<b>\$ 3,543</b>
Six Months Ended May 31, 2005(3)	Institutional	Global Wealth Management	Asset	Discover	Intersegment	Total
	Securities	Group	Management		Eliminations	
	(dollars in millions)					
Net revenues excluding net interest	\$ 6,463	\$ 2,312	\$ 1,336	\$ 1,203	\$ (137)	\$ 11,177
Net interest	892	154	2	644		1,692
<b>Net revenues</b>	<b>\$ 7,355</b>	<b>\$ 2,466</b>	<b>\$ 1,338</b>	<b>\$ 1,847</b>	<b>\$ (137)</b>	<b>\$ 12,869</b>
Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net	\$ 1,890	\$ 471	\$ 462	\$ 617	\$ 49	\$ 3,489
Losses from unconsolidated investees	140					140
Provision for income taxes	455	187	175	233	19	1,069
<b>Income from continuing operations before cumulative effect of accounting change, net(2)(4)</b>	<b>\$ 1,295</b>	<b>\$ 284</b>	<b>\$ 287</b>	<b>\$ 384</b>	<b>\$ 30</b>	<b>\$ 2,280</b>
Total Assets(5)	Institutional	Global Wealth	Asset	Discover	Intersegment	Total
	Securities	Management	Management		Eliminations	
		<b>Group</b>				

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	(dollars in millions)					
At May 31, 2006	\$ 977,016	\$ 19,706	\$ 3,588	\$ 26,846	\$ (113)	\$ 1,027,043
At November 30, 2005	\$ 848,943	\$ 19,290	\$ 3,543	\$ 26,866	\$ (119)	\$ 898,523

- (1) Net revenues for the quarter and six months ended May 31, 2006 included a \$30 million advisory fee related to the Company's sale of the aircraft leasing business that was eliminated in consolidation.
- (2) See Note 15 for a discussion of discontinued operations.
- (3) Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation.
- (4) See Note 1 for a discussion of the cumulative effect of accounting change, net.
- (5) Corporate assets have been fully allocated to the Company's business segments.



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**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. Variable Interest Entities.**

Financial Accounting Standards Board ( 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 ( variable interest entities ). Variable interest entities ( VIE ) are required to be consolidated by their primary beneficiaries if they do not effectively disperse risks among parties involved. 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 is involved with various entities in the normal course of business that may be deemed to be VIEs and may hold interests therein, including debt securities, interest-only strip investments and derivative instruments that may be considered variable interests. Transactions associated with these entities include asset- and mortgage-backed securitizations and structured financings (including collateralized debt, bond or loan obligations and credit-linked notes). The Company engages in these transactions principally to facilitate client needs and as a means of selling financial assets. The Company consolidates entities in which it is deemed to be the primary beneficiary. For those entities deemed to be qualifying special purpose entities (as defined in SFAS No. 140), which includes the credit card asset securitization master trusts (see Note 4), the Company does not consolidate the entity.

The Company purchases and sells interests in entities that may be deemed to be VIEs in the ordinary course of its business. As a result of these activities, it is possible that such entities may be consolidated and deconsolidated at various points in time. Therefore, the Company's variable interests described below may not be held by the Company at the end of future quarterly reporting periods.

At May 31, 2006, in connection with its Institutional Securities business, the aggregate size of VIEs, including financial asset-backed securitization, mortgage-backed securitization, collateralized debt obligation, credit-linked note, structured note, municipal bond trust, loan and bond issuing, commodities monetization, equity-linked note and exchangeable trust entities, for which the Company was the primary beneficiary of the entities was approximately \$20 billion, which is the carrying amount of the consolidated assets recorded as Financial instruments owned that are collateral for the entities' obligations. The nature and purpose of these entities that the Company consolidated were to issue a series of notes to investors that provide the investors a return based on the holdings of the entities. These transactions were executed to facilitate client investment objectives. The structured note, equity-linked note, certain credit-linked note, certain mortgage-backed securitization, certain financial asset-backed securitization and municipal bond transactions also were executed as a means of selling financial assets. The Company holds either the entire class or a majority of the class of subordinated notes or entered into a derivative instrument with the VIE, which bears the majority of the expected losses or receives a majority of the expected residual returns of the entities. The Company consolidates these entities, in accordance with its consolidation accounting policy, and as a result eliminates all intercompany transactions, including derivatives and other intercompany transactions such as fees received to underwrite the notes or to structure the transactions. The Company accounts for the assets held by the entities as Financial instruments owned and the liabilities of the entities as Other secured financings. For those liabilities that include an embedded derivative, the Company has bifurcated such derivative in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended. The beneficial interests of these consolidated entities are payable solely from the cash flows of the assets held by the VIE.

At May 31, 2006, also in connection with its Institutional Securities business, the aggregate size of the entities for which the Company holds significant variable interests, which consist of subordinated and other classes of beneficial interests, derivative instruments, limited partnership investments and secondary guarantees, was approximately \$34.9 billion. The Company's variable interests associated with these entities, primarily credit-linked note, structured note, loan and bond issuing, collateralized debt and bond obligation, financial



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

asset-backed securitization, mortgage-backed securitization and tax credit limited liability entities, including investments in affordable housing tax credit funds and underlying synthetic fuel production plants, were approximately \$19.3 billion consisting primarily of senior beneficial interests, which represent the Company's maximum exposure to loss at May 31, 2006. The Company may hedge the risks inherent in its variable interest holdings, thereby reducing its exposure to loss. The Company's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company utilizes to hedge these risks.

**12. Guarantees.**

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 (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 disclosed 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. For this reason, the Company does not monitor its risk exposure to such derivative contracts based on derivative notional amounts; rather the Company manages its risk exposure on a fair value basis. 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.

**Financial Guarantees to Third Parties.** 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

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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.

Table of Contents

## MORGAN STANLEY

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Liquidity Guarantees.** The Company has entered into liquidity facilities with special purpose entities and other counterparties, whereby the Company is required to make certain payments if losses or defaults occur. The Company often may have recourse to the underlying assets held by the special purpose entities in the event payments are required under such liquidity facilities.

The table below summarizes certain information regarding these guarantees at May 31, 2006:

Type of Guarantee	Maximum Potential Payout/Notional					Carrying Amount	Collateral/Recourse
	Years to Maturity				Total		
	Less than 1	1-3	3-5	Over 5			
	(dollars in millions)						
Derivative contracts	\$ 584,360	\$ 466,007	\$ 924,778	\$ 651,927	\$ 2,627,072	\$ 24,075	\$ 115
Standby letters of credit and other financial guarantees	1,410	507	688	3,189	5,794	156	1,571
Market value guarantees	16	171	32	645	864	50	121
Liquidity facilities	963	496	49	100	1,608		

**Indemnities.** In the normal course of its business, 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. In addition, any such guarantee obligation would be apportioned among the other non-defaulting members of the exchange or clearinghouse. 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.

**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

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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. The maximum potential amount of future payments that the Company could be required to make under these provisions at May 31, 2006 and November 30, 2005 was \$304 million and \$349 million, respectively. As of May 31, 2006 and November 30, 2005, the Company's accrued liability for distributions that the Company has determined it is probable it will be required to refund based on the applicable refund criteria specified in the various partnership agreements was \$32 million and \$36 million, respectively.

**Securitized Asset Guarantees.** As part of the Company's Institutional Securities and Discover securitization activities, the Company provides representations and warranties that certain securitized assets conform to

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

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 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 May 31, 2006 and November 30, 2005, the maximum potential amount of future payments the Company may be required to make under its surety bond was \$137 million and \$157 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.

**Merchant Chargeback Guarantees.** In connection with its Discover business, the Company issues general purpose credit cards in the U.S. and U.K. and owns and operates the Discover Network in the U.S. The Company is contingently liable for transactions processed on the Discover Network in the event of a dispute between the cardmember and a merchant. If a dispute is resolved in the cardmember's favor, the Discover Network will credit or refund the disputed amount to the Discover Network card issuer, who in turn credits its cardmember's account. Discover Network will then charge back the transaction to the merchant. If the Discover Network is unable to collect the amount from the merchant, it will bear the loss for the amount credited or refunded to the cardmember. In most instances, a payment requirement by the Discover Network is unlikely to arise because most products or services are delivered when purchased, and credits are issued by merchants on returned items in a timely fashion. However, where the product or service is not provided until some later date following the purchase, the likelihood of payment by the Discover Network increases. Similarly, the Company is also contingently liable for the resolution of cardmember disputes associated with its general purpose credit cards issued by its U.K. chartered bank on the MasterCard network. The maximum potential amount of future payments related to these contingent liabilities is estimated to be the total Discover Network sales transaction volume processed to date as well as the total U.K. cardmember sales transaction volume billed to date that could qualify as a valid disputed transaction under the Company's merchant processing network, issuer and cardmember agreements; however, the Company believes that this amount is not representative of the Company's actual potential loss exposure based on the Company's historical experience. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

The table below summarizes certain information regarding merchant chargeback guarantees during the quarters and six month periods ended May 31, 2006 and 2005:

	<b>Three Months Ended May 31,</b>		<b>Six Months Ended May 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Losses related to merchant chargebacks (dollars in millions)	\$ 1.4	\$ 1.9	\$ 1.9	\$ 3.9

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Aggregate credit card transaction volume (dollars in billions)	24.8	21.2	48.0	42.0
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Table of Contents

## MORGAN STANLEY

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The amount of the liability related to the Company's credit cardmember merchant guarantee was not material at May 31, 2006. The Company mitigates this risk by withholding settlement from merchants or obtaining escrow deposits from certain merchants that are considered higher risk due to various factors such as time delays in the delivery of products or services. The table below provides information regarding the settlement withholdings and escrow deposits:

	At	At
	May 31, 2006	November 30, 2005
	_____	_____
	(dollars in millions)	
Settlement withholdings and escrow deposits	\$ 49	\$ 42

*Other.* 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.

**13. Investments in Unconsolidated Investees.**

The Company invests in unconsolidated investees that own synthetic fuel production plants. The Company accounts for these investments under the equity method of accounting. The Company's share of the operating losses generated by these investments is recorded within Losses from unconsolidated investees, and the tax credits and the tax benefits associated with these operating losses are recorded within the Company's Provision for income taxes.

The table below provides information regarding the losses from unconsolidated investees, tax credits and tax benefits on the losses:

Three Months Ended		Six Months Ended	
May 31,		May 31,	
_____		_____	
2006	2005	2006	2005
_____	_____	_____	_____

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	(dollars in millions)			
Losses from unconsolidated investees	\$ 103	\$ 67	\$ 172	\$ 140
Tax credits		67	74	145
Tax benefits on losses	40	27	67	56

Under the current tax law, synthetic fuels tax credits are granted under Section 45K of the Internal Revenue Code. Synthetic fuels tax credits are available in full only when the price of oil is less than a base price specified by the tax code, as adjusted for inflation ( Base Price ). The Base Price for each calendar year is determined by the Secretary of the Treasury by April 1 of the following year. If the annual average price of a barrel of oil in 2006 or future years exceeds the applicable Base Price, the synthetic fuels tax credits generated by the Company s synthetic fuel facilities will be phased out, on a ratable basis, over the phase-out range. Synthetic fuels tax credits realized in prior years are not affected by this limitation. Due to the high level of crude oil prices in fiscal 2006 and continued uncertainty regarding the value of tax credits associated with synthetic fuel investments, two of the Company s investees idled production at their synthetic fuel production facilities during

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

May 2006. Additionally, based on fiscal year to date and futures prices at May 31, 2006, the Company estimates that there will be a partial phase-out of tax credits earned in fiscal 2006. The impact of this anticipated partial phase-out is included within Losses from unconsolidated investees and the Provision for income taxes for the quarter and six months ended May 31, 2006.

In fiscal 2006, the Company entered into derivative contracts designed to reduce its exposure to rising oil prices and the potential phase-out of the synthetic fuels tax credits for 2006. Changes in fair value relative to these derivative contracts are included within Principal transactions-trading revenues.

**14. 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 May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(dollars in millions)			
Service cost, benefits earned during the period	\$ 35	\$ 33	\$ 70	\$ 66
Interest cost on projected benefit obligation	37	35	74	70
Expected return on plan assets	(34)	(32)	(68)	(64)
Net amortization and other	12	9	24	18
<b>Net periodic benefit expense</b>	<b>\$ 50</b>	<b>\$ 45</b>	<b>\$ 100</b>	<b>\$ 90</b>

**15. Discontinued Operations.**

On August 17, 2005, the Company announced that its Board of Directors had approved management's recommendation to sell the Company's non-core aircraft leasing business. In connection with this action, the aircraft leasing business was classified as "held for sale" and reported as discontinued operations in the Company's condensed consolidated financial statements.

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On January 30, 2006, the Company announced that it had signed a definitive agreement under which it would sell its aircraft leasing business to Terra Firma, a European private equity group, for approximately \$2.5 billion in cash and the assumption of liabilities. The sale was completed on March 24, 2006. The results for discontinued operations in the quarter ended February 28, 2006 include a loss of \$125 million (\$75 million after-tax) related to the impact of the finalization of the sales proceeds and balance sheet adjustments related to the closing.

The quarter and six month period of fiscal 2006 reflected net income of \$8 million and a net loss of \$25 million on discontinued operations, respectively. The results for the second quarter of fiscal 2006 reflected the results of operations of the aircraft leasing business through the date of sale.

*Summarized financial information for the Company's discontinued operations:*

The table below provides information regarding amounts included within discontinued operations (dollars in millions):

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
Pre-tax gain/(loss) on discontinued operations	\$ 14	\$ (5)	\$ (42)	\$ 2

Table of Contents

## MORGAN STANLEY

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of the assets and liabilities of the Company's aircraft leasing business:

	At November 30, 2005
	(dollars in millions)
<b>Assets:</b>	
Aircraft under operating leases	\$ 3,145
Other assets	54
<b>Total assets</b>	<b>\$ 3,199</b>
<b>Liabilities:</b>	
Payable to affiliates	\$ 2,055
Other liabilities	690
<b>Total liabilities</b>	<b>\$ 2,745</b>

**16. Business Acquisitions.**

**Goldfish.** On February 17, 2006, the Company completed the acquisition of the Goldfish credit card business in the U.K. The Company believes that the acquisition of Goldfish will add economies of scale through better utilization of the existing U.K. infrastructure and strengthen its position in the U.K. credit card market. Since the acquisition date, the results of Goldfish have been included within the Discover business segment. The acquisition price was approximately \$1,676 million, which was paid in cash during February 2006. The Company recorded goodwill and other intangible assets of approximately \$355 million in connection with the acquisition. The acquisition price is still subject to finalization, and the allocation of the price is preliminary and is subject to further adjustment as the valuation of certain intangible assets is still in process.

The following table summarizes the fair values of the assets acquired and the liabilities assumed at the date of the acquisition.

At  
February 17,

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	<b>2006</b>
	<b>(dollars in millions)</b>
Consumer loans	\$ 1,316
Goodwill	232
Amortizable intangible assets	123
Other assets	20
<b>Total assets acquired</b>	<b>1,691</b>
Total liabilities assumed	15
<b>Net assets acquired</b>	<b>\$ 1,676</b>

The \$123 million of acquired amortizable intangible assets includes customer relationships of \$54 million (15-year estimated useful life) and trademarks of \$69 million (25-year estimated useful life).

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**17. Income Tax Examinations.**

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 U.K., and 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, which recently began, covers 1999-2004. The Company has filed an appeal with respect to unresolved issues relative to the IRS examination of years 1994-1998. The Company believes that the settlement of the IRS examination of years 1994-1998 will not have a material negative impact on the condensed consolidated statement of income of the Company. 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 tax reserves that the Company believes are adequate in relation to the potential for additional assessments. Once established, the Company 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 condensed consolidated financial condition of the Company, although a resolution could have a material impact on the Company's condensed consolidated statement of income for a particular future period and on the Company's effective income tax rate for any period in which such resolution occurs.

**18. Insurance Settlement.**

On September 11, 2001, the U.S. experienced terrorist attacks targeted against New York City and Washington, D.C. The attacks in New York resulted in the destruction of the World Trade Center complex, where approximately 3,700 of the Company's employees were located, and the temporary closing of the debt and equity financial markets in the U.S. Through the implementation of its business recovery plans, the Company relocated its displaced employees to other facilities.

In the first quarter of fiscal 2005, the Company settled its claim with its insurance carriers related to the events of September 11, 2001. The Company recorded a pre-tax gain of \$251 million as the insurance recovery was in excess of previously recognized costs related to the terrorist attacks (primarily write-offs of leasehold improvements and destroyed technology and telecommunications equipment in the World Trade Center complex, employee relocation and certain other employee-related expenditures).

The pre-tax gain, which was recorded as a reduction to non-interest expenses, is included within the Global Wealth Management Group (\$198 million), Asset Management (\$43 million) and Institutional Securities (\$10 million) segments. The insurance settlement was allocated to the respective segments in accordance with the relative damages sustained by each segment.

**19. Lease Adjustment.**

Prior to the first quarter of fiscal 2005, the Company did not record the effects of scheduled rent increases and rent-free periods for certain real estate leases on a straight-line basis. In addition, the Company had been accounting for certain tenant improvement allowances as reductions to the related leasehold improvements instead of recording funds received as deferred rent and amortizing them as reductions to lease expense over the lease term. In the first quarter of fiscal 2005, the Company changed its method of accounting for these rent escalation clauses, rent-free periods and tenant improvement allowances to properly reflect lease expense over the lease term on a straight-line basis. The impact of this

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correction resulted in the Company recording \$109 million of additional rent expense in the first quarter of fiscal 2005. The impact of this change was included within non-interest expenses and reduced income before taxes within the Institutional Securities (\$71 million), Global Wealth Management Group (\$29 million), Asset Management (\$5 million) and Discover (\$4 million) segments. The impact of this correction to the six month period of fiscal 2005 was not material to the pre-tax income of each of the segments or to the Company.



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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**20. New Accounting Developments.**

In June 2005, the FASB ratified the consensus reached in Emerging Issues Task Force ( EITF ) Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights. Under the provisions of EITF Issue No. 04-5, a general partner in a limited partnership is presumed to control that limited partnership and therefore should include the limited partnership in its consolidated financial statements regardless of the amount or extent of the general partner's interest unless a majority of the limited partners can vote to dissolve or liquidate the partnership or otherwise remove the general partner without having to show cause or the limited partners have substantive participating rights that can overcome the presumption of control by the general partner. EITF Issue No. 04-5 was effective immediately for all newly formed limited partnerships and existing limited partnerships for which the partnership agreements have been modified. For all other existing limited partnerships for which the partnership agreements have not been modified, the Company is required to adopt EITF Issue No. 04-5 on December 1, 2006 in a manner similar to a cumulative-effect-type adjustment or by retrospective application. The Company is currently assessing the impact on these existing limited partnerships of adopting the provisions of EITF Issue No. 04-5; however, because the Company generally expects to provide limited partners in these funds with rights to remove the Company as general partner or rights to terminate the partnership, the Company does not expect the impact of EITF Issue No. 04-5 to be material.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS No. 133 and SFAS No. 140. SFAS No. 155 permits hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation to irrevocably be accounted for at fair value, with changes in fair value recognized in the statement of income. The fair value election may be applied on an instrument-by-instrument basis. SFAS No. 155 also eliminates a restriction on the passive derivative instruments that a qualifying special purpose entity may hold. SFAS No. 155 is effective for those financial instruments acquired or issued after December 1, 2006. At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid financial instrument and the fair value of the combined hybrid financial instrument will be recognized as a cumulative-effect adjustment to beginning retained earnings. The Company is currently evaluating the potential impact of adopting SFAS No. 155.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140. SFAS No. 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. The standard permits an entity to subsequently measure each class of servicing assets or servicing liabilities at fair value and report changes in fair value in the statement of income in the period in which the changes occur. SFAS No. 156 is effective for the Company as of December 1, 2006. The Company is currently evaluating the potential impact of adopting SFAS No. 156.

In April 2006, the FASB issued FASB Staff Position No. FIN 46(R)-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R) ( FSP FIN 46(R)-6 ). FSP FIN 46(R)-6 requires that the determination of the variability to be considered in applying FIN 46R be based on an analysis of the design of the entity. In evaluating whether an interest with a variable interest entity creates or absorbs variability, FSP FIN 46(R)-6 focuses on the role of a contract or arrangement in the design of an entity, regardless of its legal form or accounting classification. The Company will adopt the guidance in FSP FIN 46(R)-6 prospectively beginning September 1, 2006 to all entities that the Company first becomes involved with and to all entities previously required to be analyzed under FIN 46R when a reconsideration event has occurred under paragraph 7 of FIN 46R. The Company does not expect the adoption of FSP FIN 46(R)-6 to have a material impact on its condensed consolidated financial statements.



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. Subsequent Events.**

**Office Building.** In June 2006, the Company purchased a significant interest in a joint venture that indirectly owns title to 522 Fifth Avenue, a 23-floor office building in New York City (the Building), for approximately \$420 million. Concurrently, the Company entered into an occupancy agreement with the joint venture pursuant to which the Company will occupy the office space in the Building (approximately 580,000 square feet).

**TransMontaigne Inc.** In June 2006, Morgan Stanley Capital Group Inc., a wholly-owned subsidiary of the Company, entered into a definitive Agreement and Plan of Merger to effect the acquisition of TransMontaigne Inc., a Denver-based company that operates pipelines, terminals and barges, and distributes and markets refined petroleum products. The Company will purchase the outstanding common shares of TransMontaigne Inc. for \$11.35 per share, or an aggregate cost of approximately \$610 million. The transaction is subject to customary closing conditions and is expected to be completed during the third or fourth quarter of fiscal 2006.

**Preferred Stock.** In July 2006, the Company issued \$1 billion of Floating Rate Non-Cumulative Preferred Stock, Series A.

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

Morgan Stanley:

We have reviewed the accompanying condensed consolidated statement of financial condition of Morgan Stanley and subsidiaries (the Company) as of May 31, 2006, and the related condensed consolidated statements of income and comprehensive income for the three-month and six-month periods ended May 31, 2006 and 2005, and condensed consolidated statements of cash flows for the six-month periods ended May 31, 2006 and 2005. These interim financial statements are the responsibility of the management of Morgan Stanley.

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 Morgan Stanley and subsidiaries as of November 30, 2005, 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 for the fiscal year ended November 30, 2005; and in our report dated February 8, 2006, which report contains an explanatory paragraph relating to the adoption in 2005 of Statement of Financial Accounting Standards No. 123(R), Share-Based Payment and the change in classification of repurchase transactions in the consolidated statements of cash flows, 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, 2005 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 to the condensed consolidated interim financial statements, effective December 1, 2005, Morgan Stanley changed its accounting policy for recognition of equity awards granted to retirement-eligible employees.

/s/ DELOITTE & TOUCHE LLP  
New York, New York

July 6, 2006

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**Table of Contents**

**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, Asset Management and Discover. The Company, through its subsidiaries and affiliates, provides its 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 securities and related products 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 insurance products; credit and other lending products; banking and cash management and credit solutions; retirement services; trust and fiduciary services; and engages in investment activities.

*Asset Management* provides global asset management products and services in equities, fixed income and alternative investment products through three principal distribution channels: a proprietary channel consisting of the Company's representatives; a non-proprietary channel consisting of third-party broker-dealers, banks, financial planners and other intermediaries; and the Company's institutional sales channel; and engages in investment activities.

*Discover* offers Discover®-branded credit cards and other consumer products and services, and includes the operations of Discover Network, which operates a merchant and cash access network for Discover Network branded cards, and PULSE EFT Association LP (PULSE), an automated teller machine/debit and electronic funds transfer network. The Discover business segment also includes consumer finance products and services in the U.K., including Morgan Stanley-branded, Goldfish-branded and various other credit cards issued on the MasterCard network.

The discussion of the Company's results of operations below (including Business Outlook) 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, 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, 2005 (the Form 10-K), Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's 2006 Quarterly Reports on Form 10-Q and in other items throughout the Form 10-K, Forms 10-Q and the Company's 2006 Current Reports on Form 8-K.

The Company's results of operations for the quarters and six month periods ended May 31, 2006 and 2005 are discussed below. The results of the Company's aircraft leasing business are reported as discontinued operations for all periods presented (see Discontinued Operations herein).



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

	<b>Three Months</b>		<b>Six Months</b>	
	<b>Ended May 31,</b>		<b>Ended May 31,</b>	
	<b>2006</b>	<b>2005(1)</b>	<b>2006</b>	<b>2005(1)</b>
<b>Net revenues (dollars in millions):</b>				
Institutional Securities	\$ 5,726	\$ 3,340	\$ 11,200	\$ 7,355
Global Wealth Management Group	1,402	1,228	2,686	2,466
Asset Management	723	642	1,418	1,338
Discover	1,191	888	2,280	1,847
Intersegment Eliminations	(98)	(67)	(157)	(137)
<b>Consolidated net revenues</b>	<b>\$ 8,944</b>	<b>\$ 6,031</b>	<b>\$ 17,427</b>	<b>\$ 12,869</b>
<b>Income before taxes (dollars in millions)(2):</b>				
Institutional Securities	\$ 2,267	\$ 813	\$ 4,021	\$ 1,890
Global Wealth Management Group	157	118	180	471
Asset Management	224	175	396	462
Discover	541	263	1,020	617
Intersegment Eliminations	(13)	25	6	49
<b>Consolidated income before taxes</b>	<b>\$ 3,176</b>	<b>\$ 1,394</b>	<b>\$ 5,623</b>	<b>\$ 3,489</b>
<b>Consolidated net income (dollars in millions)</b>	<b>\$ 1,957</b>	<b>\$ 928</b>	<b>\$ 3,518</b>	<b>\$ 2,330</b>
<b>Earnings per basic share:</b>				
Income from continuing operations	\$ 1.92	\$ 0.88	\$ 3.48	\$ 2.15
Income (loss) on discontinued operations	0.01		(0.02)	
Cumulative effect of accounting change, net				0.05
<b>Earnings per basic share</b>	<b>\$ 1.93</b>	<b>\$ 0.88</b>	<b>\$ 3.46</b>	<b>\$ 2.20</b>
<b>Earnings per diluted share:</b>				
Income from continuing operations	\$ 1.85	\$ 0.86	\$ 3.35	\$ 2.10
Income (loss) on discontinued operations	0.01		(0.02)	
Cumulative effect of accounting change, net				0.05
<b>Earnings per diluted share</b>	<b>\$ 1.86</b>	<b>\$ 0.86</b>	<b>\$ 3.33</b>	<b>\$ 2.15</b>

**Statistical Data.**

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<b>Book value per common share(3)</b>	\$ 30.09	\$ 26.07	\$ 30.09	\$ 26.07
<b>Average common equity (dollars in billions)(4):</b>				
Institutional Securities	18.1	14.3	17.1	14.1
Global Wealth Management Group	3.3	3.6	3.4	3.7
Asset Management	2.1	1.7	2.0	1.7
Discover	5.0	4.2	4.8	4.3
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total from operating segments	28.5	23.8	27.3	23.8
Discontinued operations		1.5		1.5
Unallocated capital	2.7	3.1	3.1	3.1
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Consolidated	\$ 31.2	\$ 28.4	\$ 30.4	\$ 28.4
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>



**Table of Contents***Statistical Data (Continued).*

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005(1)	2006	2005(1)
<b>Return on average common equity(4):</b>				
Consolidated	25%	13%	23%	16%
Institutional Securities	30%	16%	30%	18%
Global Wealth Management Group	13%	8%	7%	15%
Asset Management	26%	25%	24%	33%
Discover	27%	16%	27%	18%
<b>Effective income tax rate</b>	<b>36.6%</b>	<b>29.8%</b>	<b>35.0%</b>	<b>32.1%</b>
<b>Worldwide employees</b>	<b>53,163</b>	<b>54,142</b>	<b>53,163</b>	<b>54,142</b>
<b>Consolidated assets under management or supervision (dollars in billions):</b>				
Equity	\$ 303	\$ 265	\$ 303	\$ 265
Fixed income	109	106	109	106
Money market	80	84	80	84
Alternative investments	20	18	20	18
Real estate	52	33	52	33
Total assets under management	564	506	564	506
Unit investment trusts	13	11	13	11
Other(5)	48	48	48	48
Total assets under management or supervision(6)	\$ 625	\$ 565	\$ 625	\$ 565
<b>Institutional Securities:</b>				
Mergers and acquisitions completed transactions (dollars in billions)(7):				
Global market volume	\$ 174.4	\$ 95.5	\$ 284.2	\$ 124.2
Market share	31.7%	25.4%	30.0%	20.5%
Rank	2	2	2	4
Mergers and acquisitions announced transactions (dollars in billions)(7):				
Global market volume	\$ 199.9	\$ 200.9	\$ 350.7	\$ 324.7
Market share	20.0%	34.0%	23.6%	33.3%
Rank	4	1	5	1
Global equity and equity-related issues (dollars in billions)(7):				
Global market volume	\$ 18.8	\$ 5.7	\$ 23.7	\$ 15.5
Market share	9.7%	6.3%	8.7%	9.4%
Rank	2	6	3	4
Global debt issues (dollars in billions)(7):				
Global market volume	\$ 99.0	\$ 84.1	\$ 173.0	\$ 154.3
Market share	6.2%	5.8%	6.4%	6.1%
Rank	5	5	5	4
Global initial public offerings (dollars in billions)(7):				
Global market volume	\$ 7.5	\$ 2.1	\$ 8.9	\$ 4.8
Market share	11.7%	8.6%	10.3%	10.9%
Rank	2	2	2	1

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Pre-tax profit margin(8)

40%

24%

36%

26%

**Table of Contents***Statistical Data (Continued).*

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005(1)	2006	2005(1)
<b>Global Wealth Management Group:</b>				
Global representatives	8,179	10,438	8,179	10,438
Annualized net revenue per global representative (dollars in thousands)(9)	\$ 653	\$ 470	\$ 607	\$ 461
Client assets by segment (dollars in billions)				
\$10 million or more	\$ 172	\$ 148	\$ 172	\$ 148
\$1 million \$10 million	225	211	225	211
\$100,000 \$1 million	183	190	183	190
Less than \$100,000	29	36	29	36
Client assets excluding corporate and other accounts	609	585	609	585
Corporate and other accounts	30	28	30	28
Total client assets	\$ 639	\$ 613	\$ 639	\$ 613
Fee-based assets as a percentage of total client assets	30%	27%	30%	27%
Bank deposit program (dollars in millions)(10)	\$ 9,114	\$ 446	\$ 9,114	\$ 446
Pre-tax profit margin(8)	11%	10%	7%	19%
<b>Asset Management:</b>				
Assets under management or supervision (dollars in billions)	\$ 440	\$ 416	\$ 440	\$ 416
Percent of fund assets in top half of Lipper rankings(11)	48%	76%	48%	76%
Pre-tax profit margin(8)	31%	27%	28%	35%
Pre-tax profit margin(8) (excluding private equity)	25%	29%	25%	34%
<b>Discover (dollars in millions, unless otherwise noted)(12):</b>				
Period-end credit card loans Owned	\$ 21,764	\$ 19,385	\$ 21,764	\$ 19,385
Period-end credit card loans Managed	\$ 48,539	\$ 46,845	\$ 48,539	\$ 46,845
Average credit card loans Owned	\$ 19,664	\$ 18,753	\$ 20,808	\$ 18,979
Average credit card loans Managed	\$ 47,307	\$ 47,146	\$ 47,439	\$ 48,028
Net principal charge-off rate Owned	3.02%	4.62%	3.82%	4.62%
Net principal charge-off rate Managed	3.30%	4.94%	4.18%	5.03%
Return on average receivables Owned	6.83%	3.48%	6.15%	4.06%
Return on average receivables Managed	2.84%	1.38%	2.70%	1.60%
Transaction volume (dollars in billions):				
Net sales	\$ 24.0	\$ 21.1	\$ 46.5	41.9
Other transaction volume	4.5	4.3	8.9	9.4
Total	\$ 28.5	\$ 25.4	\$ 55.4	\$ 51.3
Payment services transaction volume (in millions):				
Discover network	340	315	679	629
PULSE network	471	457	896	673
Total network transaction volume	811	772	1,575	1,302
Pre-tax profit margin(8)	45%	30%	45%	33%



**Table of Contents**

- (1) Certain prior-period information has been reclassified to conform to the current period's presentation.
- (2) Amounts represent income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net.
- (3) Book value per common share equals shareholders' equity of \$32,255 million at May 31, 2006 and \$28,330 million at May 31, 2005, divided by common shares outstanding of 1,072 million at May 31, 2006 and 1,087 million at May 31, 2005, respectively.
- (4) The Company uses an economic capital model to determine the amount of equity capital needed to support the risk of its business activities and to ensure that the Company remains adequately capitalized. Economic capital is defined as the amount of capital needed to run the business through the business cycle and satisfy the requirements of regulators, rating agencies and the market. The Company's methodology is based on an approach that assigns economic capital to each segment based on regulatory capital usage plus additional capital for stress losses, goodwill and principal investment risk. The economic capital model and allocation methodology may be enhanced over time in response to changes in the business and regulatory environment. The effective tax rates used in the computation of segment return on average common equity were determined on a separate entity basis.
- (5) Amounts include assets under management or supervision associated with the Global Wealth Management Group business.
- (6) Revenues and expenses associated with these assets are included in the Company's Asset Management, Global Wealth Management Group and Institutional Securities segments.
- (7) Source: Thomson Financial, data as of June 7, 2006. The data for the three months ended May 31, 2006 and 2005 are for the periods from March 1 to May 31, 2006 and March 1 to May 31, 2005, respectively. The data for the six months ended May 31 are for the periods from January 1 to May 31, 2006 and January 1 to May 31, 2005, respectively, as Thomson Financial presents these data on a calendar-year basis.
- (8) Percentages represent income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net as a percentage of net revenues.
- (9) Amounts equal to Global Wealth Management Group's net revenues divided by average global representative headcount for the periods represented.
- (10) Bank deposits are held at certain of the Company's Federal Deposit Insurance Corporation insured depository institutions for the benefit of retail clients through their brokerage accounts.
- (11) Source: Lipper, one-year performance excluding money market funds as of May 31, 2006 and 2005, respectively.
- (12) Managed data include owned and securitized credit card loans. For an explanation of managed data and a reconciliation of credit card loan and asset quality data, see "Discover Managed General Purpose Credit Card Loan Data" herein.

***Second Quarter 2006 Performance.***

**Company Results.** The Company recorded net income of \$1,957 million for the quarter ended May 31, 2006, an increase of 111% from the comparable fiscal 2005 period. Net revenues (total revenues less interest expense and the provision for loan losses) increased 48% to a record \$8,944 million. Non-interest expenses of \$5,768 million increased 24% from the prior year period, primarily due to higher compensation costs. Diluted earnings per share were \$1.86 compared with \$0.86 in the second quarter of fiscal 2005. The annualized return on average common equity was 25.1% compared with 13.1% in the second quarter of last year.

For the six month period ended May 31, 2006, net income was \$3,518 million, a 51% increase from \$2,330 million a year ago. Net revenues rose 35% to \$17,427 million and non-interest expenses increased 26% to \$11,804 million. Diluted earnings per share were \$3.33 compared with \$2.15 a year ago. The annualized return on average common equity for the six month period was 23.1% compared with 16.4% in the prior year period.

The pre-tax results for the six month period ended May 31, 2005 included a \$360 million charge related to the Coleman litigation matter, a \$109 million charge for the correction in the method of accounting for certain real estate leases, and a gain of \$251 million related to an insurance settlement (see "Other Items" herein). The pre-tax results for the quarter and six month period ended May 31, 2005 also included legal accruals of approximately \$120 million related to the Parmalat matter.

The Company's effective income tax rate was 36.6% and 35.0% for the quarter and six month period ended May 31, 2006 compared with 29.8% and 32.1% in the quarter and six month period ended May 31, 2005. The increase in both periods primarily reflected lower estimated domestic tax credits and higher earnings, which reduced the effect of permanent differences. The decrease in domestic tax credits was primarily due to the anticipated partial phase-out of the benefits of synthetic fuel tax credits as a result of the high level of crude oil prices.

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*Institutional Securities.* Institutional Securities recorded income from continuing operations of \$2,267 million before losses from unconsolidated investees, income taxes and net cumulative effect of accounting change, a 179% increase from last year's second quarter. Net revenues rose 71% to a record \$5,726 million. The increases

**Table of Contents**

were driven by near-record fixed income and equity sales and trading revenues, along with higher investment banking revenues. Non-interest expenses increased 37% to \$3,459 million, reflecting higher compensation accruals primarily resulting from higher net revenues.

Investment banking advisory revenues increased 8% from last year's second quarter to \$385 million. Underwriting revenues rose 77% from last year's second quarter to \$670 million.

Fixed income sales and trading revenues were a near-record \$2,366 million, up 95% from the second quarter of fiscal 2005. The increase was driven by record results in credit products and the second best quarter ever in commodities. Credit products benefited from significantly improved performance in corporate credit trading following a weak second quarter of fiscal 2005 and continuing strong results in residential and commercial securitized products. The increase in commodities revenues primarily reflected strong revenues from electricity and natural gas products. These and related businesses continued to benefit from high market volatility and activity levels. Interest rate and currency product revenues were up slightly, benefiting from strong client flows and higher foreign exchange trading revenues. Equity sales and trading revenues were \$1,724 million, an increase of 54% as compared with the prior year quarter and were the second best quarter on record. The increase was driven by higher revenues from derivatives and equity cash products, a strong performance in principal trading strategies and record results in the prime brokerage business.

Principal transaction net investment revenues increased 163% to \$595 million in the quarter from the corresponding period in the prior year. The increase primarily reflected net gains from investments in the Company's real estate funds, Grifols S.A., Wacker Chemie AG and the NYSE Group, Inc.

*Global Wealth Management Group.* Global Wealth Management Group recorded income of \$157 million before taxes and net cumulative effect of accounting change, an increase of 33% from the second quarter of fiscal 2005. Net revenues increased 14% from last year's second quarter to \$1,402 million, driven by higher net interest revenues primarily resulting from the bank deposit program, and higher revenues from commissions and asset management, distribution and administration fees. The increase in net revenues also reflected higher investment banking and principal transaction investment revenues. Total non-interest expenses increased 12% from a year ago to \$1,245 million, reflecting increased compensation due, in part, to higher revenues as well as severance-related costs. Total client assets increased to \$639 billion, up 4% from last year's second quarter. Client assets in fee-based accounts rose 15% to \$190 billion at May 31, 2006 and increased to a record 30% of total client assets from 27% a year ago. At quarter-end, the number of global representatives was 8,179, a decline of 2,259 from a year ago, resulting largely from planned sales force reductions completed during the first half of fiscal 2006 and during the latter half of fiscal 2005 and attrition.

*Asset Management.* Asset Management recorded income of \$224 million before taxes and net cumulative effect of accounting change, a 28% increase from last year's second quarter. Net revenues of \$723 million increased 13% from a year ago, largely due to higher private equity revenues. Non-interest expenses increased 7% to \$499 million, primarily due to higher compensation and benefits expense associated with a higher level of net revenues, partially offset by lower non-compensation expenses. Assets under management or supervision within Asset Management of \$440 billion were up \$24 billion, or 6%, from the second quarter of last year, primarily due to market appreciation, partially offset by customer net outflows.

*Discover.* Discover had record income of \$541 million before losses from unconsolidated investees, income taxes and net cumulative effect of accounting change, an increase of 106% from the second quarter of fiscal 2005. Record net revenues of \$1,191 million were 34% higher than a year ago, primarily due to higher servicing and securitization income and a lower provision for consumer loan losses. Servicing and securitization income of \$651 million increased 54% from a year ago due primarily to lower charge-offs associated with the securitized portfolio. The provision for consumer loan losses of \$130 million declined 38% from last year reflecting lower net charge-offs, benefiting from continued improvement in underlying credit quality and lower bankruptcy filings following federal bankruptcy legislation that became effective in October 2005. Non-interest expenses of \$650 million increased 4% from a year ago, primarily due to higher compensation and operating

expenses associated with the acquisition of the



## **Table of Contents**

Goldfish credit card business in the U.K. on February 17, 2006 (see *Business Acquisitions* herein). The managed credit card net principal charge-off rate decreased 164 basis points to 3.30% from the same period a year ago. The managed over-30-day delinquency rate decreased 61 basis points to 3.29% from a year ago, and the managed over-90-day delinquency rate was 30 basis points lower than a year ago at 1.53%. Managed credit card loans were \$48,539 million at quarter-end, a 4% increase from a year ago, reflecting strong transaction volume and the Goldfish acquisition, partially offset by higher payment rates. Payment rates on managed credit card loans reached over 20% driven by improved credit quality and industry-wide trends.

### ***Business Outlook.***

Entering the third quarter of fiscal 2006, investment banking activity remained strong, although conditions in the global financial markets were weaker as compared with conditions that existed for the majority of the first half of fiscal 2006. Such conditions, along with the lower level of business activity in Institutional Securities and Global Wealth Management that typically occurs during the summer months, could affect the Company's results for the second half of fiscal 2006. In addition, although consumer bankruptcy filings remain well below historical levels, the Company expects charge-offs in the Discover segment to rise from the low second quarter levels, but remain below 5% on a managed basis, as pressures on consumers continue and bankruptcies begin to return to more normalized levels in the second half of fiscal 2006. In addition, Discover's marketing expenses are expected to increase in the second half of fiscal 2006 as compared with the six months ended May 31, 2006 in conjunction with new initiatives and typical seasonal trends. Discover remains focused on building broader acceptance of the Discover Network in the U.S., with a goal of achieving parity with the other bankcard networks by 2008.

### **Global Market and Economic Conditions in the Quarter and Six Month Period Ended May 31, 2006.**

The U.S. economy remained generally strong during the six month period ended May 31, 2006, supported by consumer spending, business investment and productivity gains, partially offset by a softer residential real estate market. U.S. consumer bankruptcy filings remained relatively low following the bankruptcy legislation that became effective in October 2005. The U.S. unemployment rate declined to 4.6% at the end of the quarter. Conditions in the equity markets were generally favorable during the majority of the second quarter, but increasing concerns over oil prices, inflation and the Federal Reserve Board's (the *Fed*) continued monetary policy actions resulted in a sell-off during the last month of the period. The Fed raised both the overnight lending rate and the discount rate on two separate occasions in the second quarter by an aggregate of 0.50% and on four separate occasions in the six month period by an aggregate of 1.00%. Subsequent to May 31, 2006, the Fed raised both the overnight lending rate and the discount rate by an additional 0.25%.

In Europe, economic growth was supported by exports, business investment and a recovery in Germany, while consumer spending declined. The European Central Bank (the *ECB*) raised the benchmark interest rate by 0.25% in the quarter and 0.50% in the six month period. Subsequent to May 31, 2006, the ECB raised the benchmark interest rate by an additional 0.25%. In the U.K., economic growth was modest and was supported by higher business investment, partially offset by a decline in consumer spending. During the quarter, the Bank of England left the benchmark interest rate unchanged.

The Japanese economy continued to recover steadily as business investment, corporate profitability and exports improved. The jobless rate continued to be near a seven-year low, which had a favorable impact on consumer confidence. The Japanese equity markets declined modestly in the quarter primarily due to concerns over higher global interest rates. Economic growth elsewhere in Asia continued, including in China, driven by strength in domestic spending and exports.

### **Business Segments.**

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The remainder of Results of Operations is presented on a business segment basis before discontinued operations. Substantially all of the operating revenues and operating expenses of the Company 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 revenues or other relevant measures.

**Table of Contents**

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the 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 Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to Global Wealth Management Group's global representatives. (Loss) income before taxes recorded in Intersegment Eliminations was \$(13) million and \$25 million in the quarters ended May 31, 2006 and 2005, respectively, and \$6 million and \$49 million in the six month periods ended May 31, 2006 and 2005, respectively. The results for the fiscal 2006 periods also included a \$30 million advisory fee related to the Company's sale of the aircraft leasing business that was eliminated in consolidation.

Certain reclassifications have been made to prior-period segment amounts to conform to the current period's presentation.

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

	<b>Three Months Ended May 31,</b>		<b>Six Months Ended May 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(dollars in millions)			
<b>Revenues:</b>				
Investment banking	\$ 1,055	\$ 735	\$ 1,958	\$ 1,477
<b>Principal transactions:</b>				
Trading	3,617	1,684	6,562	3,411
Investments	595	226	879	317
Commissions	694	538	1,304	1,041
Asset management, distribution and administration fees	73	39	117	73
Interest and dividends	9,318	5,379	19,109	10,654
Other	85	78	163	144
<b>Total revenues</b>	<b>15,437</b>	<b>8,679</b>	<b>30,092</b>	<b>17,117</b>
Interest expense	9,711	5,339	18,892	9,762
<b>Net revenues</b>	<b>5,726</b>	<b>3,340</b>	<b>11,200</b>	<b>7,355</b>
<b>Total non-interest expenses</b>	<b>3,459</b>	<b>2,527</b>	<b>7,179</b>	<b>5,465</b>
Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net	2,267	813	4,021	1,890
Losses from unconsolidated investees	103	67	171	140
Provision for income taxes	786	171	1,309	455
<b>Income from continuing operations before cumulative effect of accounting change, net</b>	<b>\$ 1,378</b>	<b>\$ 575</b>	<b>\$ 2,541</b>	<b>\$ 1,295</b>

**Investment Banking.** Investment banking revenues for the quarter increased 44% from the comparable period of fiscal 2005. The increase was due to higher revenues from equity and fixed income underwriting transactions and merger, acquisition and restructuring activities. Underwriting revenues were \$670 million, an increase of 77% from the comparable period of fiscal 2005. Equity underwriting revenues increased 156% to \$371 million, reflecting an increase in industry-wide activity and were the highest quarterly revenues since the first quarter of fiscal 2000. Fixed income underwriting revenues increased 28% to \$299 million, reflecting higher revenues from investment grade and non-investment grade fixed income products. Advisory fees from merger, acquisition and restructuring transactions were \$385 million, an increase of 8% from the comparable period of fiscal 2005. The increase in advisory fees reflected an increase in completed transactions. Advisory fees in the current quarter also included a \$30 million fee related to the Company's sale of the aircraft leasing business that was eliminated in consolidation.

At May 31, 2006, the backlog of merger, acquisition and restructuring transactions and equity underwriting transactions was higher as compared with the end of the second quarter of fiscal 2005. The backlog of both merger, acquisition and restructuring transactions and equity underwriting

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transactions is subject to the risk that transactions may not be completed due to 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.

Investment banking revenues in the six month period ended May 31, 2006 increased 33% from the comparable period of fiscal 2005. The increase was due to higher revenues from both equity and fixed income underwriting transactions and merger, acquisition and restructuring activities.

**Table of Contents**

**Sales and Trading Revenues.** 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.

Total sales and trading revenues increased 73% in the quarter ended May 31, 2006 from the comparable period of fiscal 2005, reflecting near-record fixed income and equity sales and trading revenues.

Sales and trading revenues include the following:

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005(1)	2006	2005(1)
	(dollars in millions)			
Equity	\$ 1,724	\$ 1,119	\$ 3,378	\$ 2,333
Fixed income(2)	2,366	1,211	5,090	3,209

(1) Certain reclassifications have been made to prior period amounts to conform to the current period's presentation.

(2) Amounts include interest rate and currency products, credit products and commodities. Amounts exclude revenues from corporate lending activities.

Equity sales and trading revenues increased 54% as compared with the prior year quarter and were the second best quarter on record. The increase was driven by higher revenues from derivatives and equity cash products, a strong performance in principal trading strategies and record results in the prime brokerage business. Increased client flows across both the derivatives and cash equity markets drove revenues higher, particularly in Europe and Asia. Favorable trading opportunities positively impacted the quarter's results as major global equity market indices trended higher in the beginning of the quarter. The increase in prime brokerage revenues reflected record levels of customer balances. Although commission revenues increased, revenues continued to be adversely affected by intense competition particularly in the U.S. and a continued shift toward electronic trading.

Fixed income sales and trading revenues increased 95% as compared with the prior year quarter and were the second best quarter on record. The increase reflected record results in credit products and the second best quarter ever in commodities. Credit product revenues increased 161% primarily due to record revenues from corporate credit products, which benefited from significantly improved performance in corporate credit trading following a weak second quarter of fiscal 2005 and continuing strong results in residential and commercial securitized products. Commodities revenues increased 268% and were the second best quarter on record. The increase was primarily due to strong revenues from electricity and natural gas products. Energy prices were volatile during the quarter driven by geopolitical issues and weather conditions in the U.S. Interest rate and currency product revenues increased 4% primarily due to strong client flows and higher foreign exchange trading revenue.

Total sales and trading revenues increased 51% in the six month period ended May 31, 2006 from the comparable period of fiscal 2005, reflecting higher revenues from equity and fixed income products. Equity sales and trading revenues increased 45%, driven primarily by higher revenues in derivative products, principal trading strategies, equity cash products and the prime brokerage business. Increased client flows across both the derivatives and equity cash markets and favorable trading opportunities drove revenues higher. Revenues in the prime brokerage business reflected record levels of customer balances and new customer activity. Fixed income sales and trading revenues increased 59%

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primarily due to higher revenues in commodities and credit products. Commodities revenues increased primarily due to higher revenues from electricity and natural gas products and from oil liquids. Credit product revenues increased primarily due to strong revenues in corporate credit products

**Table of Contents**

and strong demand in securitized products. Interest rate and currency product revenues decreased modestly, primarily due to lower revenues from interest rate derivatives, partially offset by higher revenues from foreign exchange products.

The increase in sales and trading results for the quarter reflected generally favorable overall market conditions as well as improved risk efficiency in comparison to the quarter ended May 31, 2005. For a further discussion of the Company's risk management policies, see Quantitative and Qualitative Disclosures about Market Risk Risk Management in Part II, Item 7A of the Form 10-K.

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 quarter ended May 31, 2006, revenues from corporate lending activities increased by approximately \$17 million, reflecting the impact of mark-to-market valuations associated with new loans made in the second quarter of fiscal 2006. In the six month period ended May 31, 2006, revenues from corporate lending activities were relatively unchanged from the comparable period of fiscal 2005.

**Principal Transactions-Investments.** Principal transaction net investment revenues increased 163% and 177% in the quarter and six month period ended May 31, 2006, respectively. The increase in both periods was primarily related to net gains associated with the Company's investments, including both realized and unrealized gains from investments in the Company's real estate funds, Grifols S.A., Wacker Chemie AG and the NYSE Group, Inc. The increase in the six month period also reflected a \$137 million net gain from the Company's position in IntercontinentalExchange.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees increased 87% in the quarter and 60% in the six month period ended May 31, 2006 from the comparable periods of fiscal 2005. The increase in both periods was primarily related to higher fees associated with real estate fund investments.

**Other.** Other revenues increased 9% and 13% in the quarter and six month period ended May 31, 2006, respectively, primarily driven by higher sales of benchmark indices and risk management analytic products.

**Non-Interest Expenses.** Non-interest expenses increased 37% and 31% in the quarter and the six month period ended May 31, 2006, respectively. Compensation and benefits expense increased 58% and 61% in the quarter and six month period, respectively, primarily reflecting higher incentive-based compensation accruals resulting from higher net revenues. The six month period also included Institutional Securities share (\$270 million) of incremental compensation expense related to equity awards to retirement-eligible employees (see Stock-Based Compensation herein). Excluding compensation and benefits expense, non-interest expenses increased 4% in the quarter and decreased 13% in the six month period. Occupancy and equipment expense decreased 22% in the six month period primarily due to a \$71 million charge that was recorded in the first quarter of fiscal 2005 for the correction in the method of accounting for certain real estate leases (see Lease Adjustment herein). Brokerage, clearing and exchange fees increased 31% and 27% in the quarter and six month period, respectively, primarily reflecting increased fixed income and equity trading activity. Professional services expense increased 31% and 21% in the quarter and six month period, respectively, primarily due to higher legal and consulting costs, reflecting increased levels of business activity. Other expense decreased 48% and 65% in the quarter and six month period, respectively, reflecting lower charges for legal and regulatory matters. Other expense in the second quarter of fiscal 2005 included legal accruals of approximately \$120 million related to the Parmalat matter and the six month period of fiscal 2005 included a \$360 million charge related to the Coleman litigation (see Legal Proceedings in Part I, Item 3 of the Form 10-K and in Part II, Item 1 herein).



Table of Contents

## GLOBAL WEALTH MANAGEMENT GROUP

## INCOME STATEMENT INFORMATION

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
(dollars in millions)				
Revenues:				
Investment banking	\$ 95	\$ 68	\$ 162	\$ 139
Principal transactions:				
Trading	121	111	245	231
Investments	26	(2)	26	(4)
Commissions	312	295	631	624
Asset management, distribution and administration fees	674	632	1,323	1,239
Interest and dividends	246	149	452	284
Other	44	45	80	83
Total revenues	1,518	1,298	2,919	2,596
Interest expense	116	70	233	130
Net revenues	1,402	1,228	2,686	2,466
Total non-interest expenses	1,245	1,110	2,506	1,995
Income before taxes and cumulative effect of accounting change, net	157	118	180	471
Provision for income taxes	51	48	60	187
Income before cumulative effect of accounting change, net	\$ 106	\$ 70	\$ 120	\$ 284

**Investment Banking.** Investment banking revenues increased 40% and 17% in the quarter and six month period ended May 31, 2006, primarily due to higher revenues from equity underwritings, including revenues from a fund private placement, and higher revenues from unit investment trust sales. The increase in investment banking revenues in the six month period was partially offset by lower revenues from fixed income underwritings.

**Principal Transactions Trading.** Principal transaction trading revenues increased 9% and 6% in the quarter and six month period ended May 31, 2006, primarily due to higher revenues from government and municipal fixed income securities as well as foreign exchange securities.

**Principal Transactions Investments.** Principal transaction investment net revenues were \$26 million in the quarter and six month period ended May 31, 2006 compared with net losses of \$(2) million and \$(4) million in the quarter and six month period ended May 31, 2005. The results in fiscal 2006 primarily reflected both realized and unrealized gains from the Company's investment in NYSE Group, Inc.

**Commissions.** Commission revenues increased 6% and 1% in the quarter and six month period ended May 31, 2006 from higher equity product revenues, primarily in international markets, in the second quarter of fiscal 2006.

**Net Interest.** Net interest revenues increased 65% and 42% in the quarter and six month period ended May 31, 2006, primarily due to increased account balances in the bank deposit program.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees increased 7% in the quarter and six month period ended May 31, 2006, primarily reflecting higher client assets in fee-based accounts.

**Table of Contents**

Client asset balances increased to \$639 billion at May 31, 2006 from \$613 billion at May 31, 2005, primarily due to market appreciation. Client assets in fee-based accounts rose 15% to \$190 billion at May 31, 2006 and increased to a record 30% of total client assets from 27% in the prior-year period.

***Non-Interest Expenses.*** Non-interest expenses increased 12% and 26% in the quarter and six month period ended May 31, 2006, primarily reflecting an increase in compensation and benefits expense. The increase in the six month period was also due to a reduction in non-interest expenses in the prior year period related to Global Wealth Management Group's share (\$198 million) of the insurance settlement related to the events of September 11, 2001 (see *Insurance Settlement* herein). Compensation and benefits expense increased 17% in both the quarter and six month period ended May 31, 2006, primarily reflecting higher incentive-based compensation costs due to higher net revenues. Compensation and benefits expense for the quarter also included severance-related costs due to the sales force reduction conducted during the period. The six month period ended May 31, 2006 included Global Wealth Management Group's share (\$80 million) of the incremental compensation expense related to equity awards to retirement-eligible employees, including new hires (see *Stock-Based Compensation* herein). Excluding compensation and benefits expense and the insurance settlement, non-interest expenses increased 5% and 9% in the quarter and six month period. Occupancy and equipment expense decreased 14% in the six month period primarily due to a \$29 million charge for the correction in the method of accounting for certain real estate leases that was recorded in the first quarter of fiscal 2005 (see *Lease Adjustment* herein). Professional services expense increased 25% and 30% in the quarter and six month period, largely due to higher legal fees, as well as higher sub-advisory fees associated with growth in fee-based assets. Other expenses increased 27% in the six month period, primarily resulting from higher costs associated with legal and regulatory matters. During the six month period ended May 31, 2006, the Company recorded legal and regulatory expenses of approximately \$80 million related to ongoing regulatory, employment and branch litigation matters.

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

	<b>Three Months Ended May 31,</b>		<b>Six Months Ended May 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(dollars in millions)			
<b>Revenues:</b>				
Investment banking	\$ 15	\$ 11	\$ 27	\$ 22
<b>Principal transactions:</b>				
Investments	69	2	99	66
Commissions	7	7	14	14
Asset management, distribution and administration fees	621	615	1,260	1,220
Interest and dividends	10	3	15	6
Other	6	6	12	14
<b>Total revenues</b>	<b>728</b>	<b>644</b>	<b>1,427</b>	<b>1,342</b>
Interest expense	5	2	9	4
<b>Net revenues</b>	<b>723</b>	<b>642</b>	<b>1,418</b>	<b>1,338</b>
<b>Total non-interest expenses</b>	<b>499</b>	<b>467</b>	<b>1,022</b>	<b>876</b>
<b>Income before taxes and cumulative effect of accounting change, net</b>	<b>224</b>	<b>175</b>	<b>396</b>	<b>462</b>
Provision for income taxes	89	68	156	175
<b>Income before cumulative effect of accounting change, net</b>	<b>\$ 135</b>	<b>\$ 107</b>	<b>\$ 240</b>	<b>\$ 287</b>

**Investment Banking.** Investment banking revenues increased 36% and 23% in the quarter and six month period ended May 31, 2006 primarily reflecting a higher volume of unit investment trust sales.

**Principal Transactions-Investments.** Principal transaction net investment gains aggregating \$69 million and \$99 million were recognized in the quarter and six month period ended May 31, 2006 as compared with net gains of \$2 million and \$66 million in the quarter and six month period ended May 31, 2005. The increase in both periods was primarily related to higher net gains on certain investments in the Company's private equity portfolio, including Aventine Renewable Energy Holdings, LLC. The results for the six month period ended May 31, 2005 included a gain on Triana Energy Holdings, LLC. Asset Management continues to wind down its legacy private equity business.

**Table of Contents**

**Asset Management, Distribution and Administration Fees.** Asset Management's period-end and average customer assets under management or supervision were as follows:

	At		Average For the Three Months Ended		Average For the Six Months Ended	
	May 31,	May 31,	May 31,	May 31,	May 31,	May 31,
	2006	2005(1)	2006	2005(1)	2006	2005(1)
(dollars in billions)						
<b>Assets under management or supervision by distribution channel:</b>						
Retail	\$ 190	\$ 199	\$ 191	\$ 201	\$ 195	\$ 202
Institutional	250	217	254	219	248	222
<b>Total assets under management or supervision</b>	<b>\$ 440</b>	<b>\$ 416</b>	<b>\$ 445</b>	<b>\$ 420</b>	<b>\$ 443</b>	<b>\$ 424</b>
<b>Assets under management or supervision by asset class:</b>						
Equity	\$ 226	\$ 205	\$ 232	\$ 203	\$ 229	\$ 203
Fixed income	91	92	90	95	91	99
Money market	75	80	76	82	77	82
Alternative investments	20	18	19	19	19	19
Real estate	15	10	15	10	14	10
<b>Total assets under management</b>	<b>427</b>	<b>405</b>	<b>432</b>	<b>409</b>	<b>430</b>	<b>413</b>
Unit investment trusts	13	11	13	11	13	11
<b>Total assets under management or supervision</b>	<b>\$ 440</b>	<b>\$ 416</b>	<b>\$ 445</b>	<b>\$ 420</b>	<b>\$ 443</b>	<b>\$ 424</b>

(1) Certain prior-period information has been reclassified to conform to the current period's presentation.

Activity in Asset Management's customer assets under management or supervision were as follows (dollars in billions):

	Three Months Ended		Six Months Ended	
	May 31,	May 31,	May 31,	May 31,
	2006	2005	2006	2005
(dollars in billions)				
<b>Balance at beginning of period</b>	\$ 442	\$ 427	\$ 431	\$ 424
Net flows excluding money markets	(1)	(4)	(6)	(12)
Net flows from money markets	(4)	(3)	(6)	(2)
Net market appreciation/(depreciation)	&n			