

12 July 2006

**BASE PROSPECTUS IN RESPECT OF THE WARRANTS AND CERTIFICATES**

**Morgan Stanley**

*as issuer and guarantor*

*(incorporated under*

*the laws of the State of Delaware in the United States of America)*

**MORGAN STANLEY (JERSEY) LIMITED**

*as issuer*

*(incorporated with limited liability in Jersey, Channel Islands)*

**MORGAN STANLEY B.V.**

*as issuer*

*(incorporated with limited liability in The Netherlands)*

**Program for the  
Issuance of Warrants and Certificates**

Under the program (the "**Program**") described in this Base Prospectus, Morgan Stanley ("**Morgan Stanley**"), Morgan Stanley (Jersey) Limited ("**Morgan Stanley Jersey**") and Morgan Stanley B.V. ("**MSBV**") or any of Morgan Stanley's subsidiaries that accedes to the Program in accordance with the terms of the Distribution Agreement (as defined herein) (each, an "**Additional Issuer**" and, together with Morgan Stanley, Morgan Stanley Jersey and MSBV, the "**Issuers**" and each, an "**Issuer**") may offer from time to time Warrants (the "**Warrants**") and Certificates (the "**Certificates**" and, together with the Warrants, the "**Securities**"). Each Additional Issuer shall prepare a base prospectus and references herein to "this Base Prospectus" shall, where applicable, be deemed to be references to this Base Prospectus as supplemented or amended from time to time. To the extent not set forth in this Base Prospectus, the specific terms of any Securities will be included in the applicable Final Terms.

This Base Prospectus has been approved by the Irish Financial Services Authority ("**IFSRA**") in its capacity as competent authority in the Republic of Ireland for the purposes of Directive 2003/71/EC (the "**Prospectus Directive**") and relevant implementing measures in the Republic of Ireland as a base prospectus issued in compliance with the Prospectus Directive and relevant implementing measures in the Republic of Ireland for the purpose of giving information with regard to the issue of Securities under the Program issued within 12 months following the date of this document. Application has also been made for the Securities issued under the Program during the period of 12 months from the date of this Base Prospectus to be admitted to the official list of the Irish Stock Exchange (the "**Official List**") and to be admitted to trading on the Irish Stock Exchange. Such applications have been made only in respect of Securities which give the right to acquire transferable securities or to receive a cash amount, as a consequence of the rights conferred by them being exercised and where the issuer of the underlying securities does not belong to the Morgan Stanley group of companies. Admission to the Official List and to trading on the Irish Stock Exchange of the Securities offered by this Base Prospectus is expected to be granted by the Irish Stock Exchange on or about 12 July 2006 subject only to issuance of Securities. The listing agent with respect to the application for the listing of the Securities on the Official List and to trading on the Irish Stock Exchange is Morgan Stanley & Co. International Limited (in conjunction with J.P. Morgan Bank (Ireland) plc). The Final Terms applicable to a Series will specify whether or not Securities of such Series have been admitted to the Official List and to trading on the Irish Stock Exchange and/or admitted to listing, trading and/or quotation by any other stock exchange, listing authority and/or quotation system.

The payment of all amounts due in respect of Securities issued by Morgan Stanley Jersey, MSBV or an Additional Issuer will, unless specified otherwise in the Final Terms to this Base Prospectus or, in the case of an Additional Issuer, in the accession agreement pursuant to which such Additional Issuer accedes to the Program, be

unconditionally and irrevocably guaranteed by Morgan Stanley (in such capacity, the "**Guarantor**") pursuant to a deed of guarantee dated as of 10 June 2002.

Each Issuer is offering the Securities on a continuing basis through Morgan Stanley & Co. International Limited and Morgan Stanley & Co. Incorporated (the "**Distribution Agents**"), who have agreed to use reasonable efforts to solicit offers to purchase the Securities. Each Issuer may also sell Securities to the Distribution Agents as principal for their own accounts at a price to be agreed upon at the time of sale. The Distribution Agents may resell any Securities they purchase as principal at prevailing market prices, or at other prices, as they determine. Each Issuer or the Distribution Agents may reject any offer to purchase Securities, in whole or in part. See "Subscription and Sale".

The European Union Transparency Obligations Directive (the "**Directive**") may be implemented in a manner which could be burdensome for companies such as an Issuer or the Guarantor (if applicable). In particular, companies may be required to publish financial statements more frequently than they otherwise would or to prepare financial statements in accordance with accounting standards other than the ones they would otherwise utilise, for example the Guarantor may be required to prepare financial statements in accordance with accounting standards other than U.S. GAAP. None of the Issuers is under any obligation to maintain the listing of any Securities, and prospective purchasers should be aware that, in circumstances where an admission to listing of the Securities by the Irish Financial Services Regulatory Authority or any other listing authority would require publication by the relevant Issuer or the Guarantor (if applicable) of financial statements more frequently than either would otherwise prepare them or preparation by Morgan Stanley (as Issuer or Guarantor, as applicable) of financial statements in accordance with standards other than U.S. GAAP, or in any other circumstances where the Directive is implemented in a manner that, in the opinion of the Issuer or the Guarantor (if applicable), is burdensome for the relevant Issuer or Guarantor (if applicable), the Securities may be de-listed. In such a case of de-listing, the relevant Issuer may, but is not obliged to, seek an alternative listing for the Securities on a stock exchange outside the European Union. However, if such an alternative listing is not available or is, in the opinion of the relevant Issuer or the Guarantor (if applicable), burdensome, an alternative listing for the Securities may not be considered. Although no assurance is made as to the liquidity of the Securities as a result of listing by the Irish Financial Services Regulatory Authority, de-listing the Securities may have a material effect on a holder's ability to resell the Securities in the secondary market.

The Securities will be governed by, and construed in accordance with, the laws of England and Wales.

**Investing in the Securities involves risks. See "Risk Factors".**

**THE SECURITIES HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE UNITED STATES SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR THE SECURITIES LAWS OF ANY STATE IN THE UNITED STATES, AND ARE SUBJECT TO U.S. TAX LAW REQUIREMENTS UNLESS OTHERWISE SPECIFIED IN THE APPLICABLE FINAL TERMS. THE SECURITIES MAY NOT BE OFFERED, SOLD OR DELIVERED AT ANY TIME, DIRECTLY OR INDIRECTLY, WITHIN THE UNITED STATES OR TO OR FOR THE ACCOUNT OF U.S. PERSONS (AS DEFINED IN EITHER REGULATION S UNDER THE SECURITIES ACT OR THE UNITED STATES INTERNAL REVENUE CODE OF 1986, AS AMENDED (THE "CODE")). SEE "SUBSCRIPTION AND SALE" AND "NO OWNERSHIP BY U.S. PERSONS."**

**Each investor must comply with all applicable laws and regulations in each country or jurisdiction in or from which the investor purchases, offers, sells or delivers the Securities or has in the investor's possession or distributes this Base Prospectus or any accompanying Final Terms.**

**MORGAN STANLEY**

The Morgan Stanley base prospectus (the "Morgan Stanley Base Prospectus") will comprise this base prospectus with the exception of (i) the information in the sections entitled (a) Morgan Stanley Jersey, (b) MSBV, (c) Jersey Taxation, (d) Netherlands Taxation, and (ii) Morgan Stanley Jersey's Annual Reports for the years ended 30 November 2004 and 30 November 2005, and MSBV's Annual Reports for the years ended 30 November 2004 and 30 November 2005 (which are either incorporated by reference, or included, in this document).

The Morgan Stanley Jersey base prospectus (the "Morgan Stanley Jersey Base Prospectus") will comprise this base prospectus with the exception of the information in the sections entitled (a) MSBV (b) Netherlands Taxation and (c) MSBV's Annual Reports for the years ended 30 November 2004 and 30 November 2005.

The MSBV base prospectus (the "MSBV Base Prospectus") will comprise this base prospectus with the exception of the information in the sections entitled (a) Morgan Stanley Jersey (b) Jersey Taxation and (c) Morgan Stanley Jersey's Annual Reports for the years ended 30 November 2004 and 30 November 2005.

Morgan Stanley accepts responsibility for information contained in the Morgan Stanley Base Prospectus, Morgan Stanley Jersey accepts responsibility for information contained in the Morgan Stanley Jersey Base Prospectus and MSBV accepts responsibility for information contained in the MSBV Base Prospectus. To the best of the knowledge and belief of each of Morgan Stanley, Morgan Stanley Jersey and MSBV (each of which has taken all reasonable care to ensure that such is the case), the information contained in each of the Morgan Stanley Base Prospectus, the Morgan Stanley Jersey Base Prospectus and the MSBV Base Prospectus respectively is in accordance with the facts and does not omit anything likely to affect the import of such information.

No person has been authorized by the Issuers or the Guarantor to give any information or to make any representation not contained or incorporated by reference in the Base Prospectus or any other document entered into in relation to the Program, and, if given or made, that information or representation should not be relied upon as having been authorized by the Issuers, the Guarantor or any of the Distribution Agents. Neither the delivery of this Base Prospectus or any Final Terms nor the offering, sale or delivery of any Securities will, in any circumstances, create any implication that the information contained in this Base Prospectus is true subsequent to the date hereof or the date upon which this Base Prospectus has been most recently amended or supplemented or that there has been no adverse change in the financial situation of any of the Issuers or the Guarantor since the date hereof or, as the case may be, the date upon which this Base Prospectus has been most recently amended or supplemented or the balance sheet date of the most recent financial statements which are deemed to be incorporated into this Base Prospectus by reference, or that any other information supplied in connection with the Program is correct at any time subsequent to the date on which it is supplied or, if different, the date indicated in the document containing the same. The Distribution Agents expressly do not undertake to review the financial condition or affairs of the Issuers or the Guarantor during the life of the Program. Investors should review, inter alia, the most recent financial statements of the relevant Issuer and, where applicable, the Guarantor when evaluating the Securities or an investment therein. Such financial statements shall not form a part of this Base Prospectus unless they have been expressly incorporated herein by way of a supplement to this Base Prospectus.

The Distribution Agents have not separately verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility is accepted by the Distribution Agents as to the accuracy or completeness of this Base Prospectus or any document incorporated by reference herein or any further information supplied in connection with any Securities. The Distribution Agents accept no liability in relation to this Base Prospectus or any document incorporated by reference herein or their distribution or with regard to any other information supplied by or on behalf of the Issuers.

Each Issuer has confirmed to the Distribution Agents that this Base Prospectus is true, accurate and complete in all material respects and is not misleading; that the opinions and intentions expressed herein are honestly held and based on reasonable assumptions; that there are no other facts in relation to the information contained or incorporated by reference in this Base Prospectus the omission of which would, in the context of the Program or the issue of the Securities, make any statement herein or opinions or intentions expressed herein misleading in any material respect; and that all reasonable enquiries have been made to verify the foregoing. Each Issuer has further confirmed to the Distribution Agents that this Base Prospectus (together with the relevant Final Terms) contains all such information as may be required by all applicable laws, rules and regulations.

The distribution of this Base Prospectus and any Final Terms and the offering, sale and delivery of the Securities in certain jurisdictions may be restricted by law. Persons into whose possession the Base Prospectus or any Final Terms comes are required by the Issuers, the Guarantor and the Distribution Agents to inform themselves about and to observe those restrictions.

Neither this Base Prospectus nor any Final Terms may be used for the purpose of an offer or solicitation by anyone in any jurisdiction in which that offer or solicitation is not authorized or to any person to whom it is unlawful to make such an offer or solicitation.

For a description of certain restrictions on offers, sales and deliveries of Securities and on the distribution of the Base Prospectus or any Final Terms and other offering material relating to the Securities, see "Subscription and Sale".

This Base Prospectus should be read and construed with any amendment or supplement hereto and with, in relation to any issue of Securities, the Final Terms (each the "Final Terms") relating thereto and with all documents incorporated by reference herein.

Neither this Base Prospectus nor any Final Terms constitutes an offer of or an invitation to subscribe for or purchase any Securities and should not be considered as a recommendation by any Issuer, the Guarantor or the Distribution Agents that any recipient of the Base Prospectus or any Final Terms should subscribe for or purchase any Securities. Each recipient of the Base Prospectus or any Final Terms will be taken to have made its own investigation and appraisal of the condition (financial or otherwise) of the Issuers and, where applicable, the Guarantor and of the particular terms of any offered Securities.

None of the Distribution Agents or any of their affiliates assumes any obligation to purchase any Securities or to make a market in the Securities, and no assurances can be given that a liquid market for the Securities will exist.

All references in this Base Prospectus to "Sterling" and "£" are to the lawful currency of the United Kingdom, all references to "U.S. dollars," "U.S.\$" and "\$" are to the lawful currency of the United States of America, all references to "Japanese Yen" and "¥" are to the lawful currency of Japan, all references to "Australian dollars" and "AUD" are to the lawful currency of the Commonwealth of Australia, all references to "New Zealand dollars" and "NZD" are to the lawful currency of New Zealand, and all references to "euro", "€" and "EUR" are to the single currency introduced at the start of the third stage of the European Economic and Monetary Union pursuant to the Treaty establishing the European Community, as amended (the "Treaty").

**IN MAKING AN INVESTMENT DECISION, INVESTORS MUST RELY ON THEIR OWN EXAMINATION OF THE RELEVANT ISSUER AND, WHERE APPLICABLE, THE GUARANTOR AND THE TERMS OF THE OFFERING, INCLUDING THE MERITS AND RISKS INVOLVED. THESE SECURITIES HAVE NOT BEEN RECOMMENDED BY ANY UNITED STATES FEDERAL OR STATE SECURITIES COMMISSION OR REGULATORY AUTHORITY. FURTHERMORE, THE FOREGOING**

**AUTHORITIES HAVE NOT CONFIRMED THE ACCURACY OR DETERMINED THE ADEQUACY OF THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

**IN CONNECTION WITH THE ISSUE OF ANY SECURITIES UNDER THE PROGRAM, ANY DISTRIBUTION AGENT OR ANY OTHER AGENT SPECIFIED FOR THAT PURPOSE IN THE APPLICABLE FINAL TERMS AS THE STABILIZING MANAGER (OR ANY PERSON ACTING FOR THE STABILIZING MANAGER) MAY OVER-ALLOT OR EFFECT TRANSACTIONS WITH A VIEW TO SUPPORTING THE MARKET PRICE OF ANY OF THE SECURITIES AT A LEVEL HIGHER THAN THAT WHICH MIGHT OTHERWISE PREVAIL FOR A LIMITED PERIOD. HOWEVER, THERE MAY BE NO OBLIGATION ON THE STABILIZING MANAGER (OR ANY AGENT OF THE STABILIZING MANAGER) TO DO THIS. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME AND MUST BE BROUGHT TO AN END AFTER A LIMITED PERIOD. SUCH STABILIZING SHALL BE IN COMPLIANCE WITH ALL APPLICABLE LAWS, REGULATIONS AND RULES.**

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## SUMMARY

*This summary has been prepared in accordance with Article 5(2) of the Prospectus Directive (Directive 2003/71/EC) (the "**Prospectus Directive**") and must be read as an introduction to the Base Prospectus prepared by each Issuer relating to the Securities referred to below. Any decision to invest in any Securities should be based on a consideration of the relevant Base Prospectus as a whole, including the documents incorporated by reference. Following implementation of the relevant provisions of the Prospectus Directive in a Member State of the European Economic Area, no civil liability will attach to the Issuer or the Guarantor (as applicable) solely on the basis of the summary, including any translation thereof, unless it is misleading, inaccurate or inconsistent when read together with the other parts of the relevant Base Prospectus. Where a claim relating to the information contained in the relevant Base Prospectus is brought before a court in a Member State of the European Economic Area, the plaintiff may, under the national legislation of the Member State where the claim is brought, be required to bear the costs of translating the relevant Base Prospectus before the legal proceedings are initiated.*

*Words and expressions defined in the "Terms and Conditions of the Securities" below or elsewhere in this Base Prospectus have the same meanings in this summary.*

### **Essential characteristics and risks associated with the Issuers and the Guarantor**

#### *Morgan Stanley*

The auditors of Morgan Stanley for the periods 1 December 2002 to 30 November 2003, 1 December 2003 to 30 November 2004 and 1 December 2004 to 30 November 2005 were Deloitte & Touche LLP, an independent registered public accounting firm.

Morgan Stanley was originally incorporated for an unlimited term under the laws of the State of Delaware on 1 October 1981 under registered number 0923632, and its predecessor companies date back to 1924. On 31 May 1997, Morgan Stanley Group, Inc. was merged with and into Dean Witter Discover & Co. ("**Dean Witter Discover**") in a merger of equals. At that time, Dean Witter Discover changed its corporate name to Morgan Stanley, Dean Witter, Discover & Co. ("**MSDWD**"). On 24 March 1998 MSDWD changed its corporate name to Morgan Stanley Dean Witter & Co, and to Morgan Stanley on 20 June 2002. Morgan Stanley has its registered office at The Corporation Trust Center, 1209 Orange Street, Wilmington, Delaware 19801, U.S.A., and its principal executive offices at 1585 Broadway, New York, New York 10036, U.S.A., telephone number +1 (212) 761-4000.

As at the date of this Base Prospectus, Morgan Stanley's legal and commercial name is "Morgan Stanley".

Morgan Stanley is a holding company that provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals, through its subsidiaries and affiliates. It 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.

Morgan Stanley's objects and purposes are set out in its Certificate of Incorporation and enable it to engage in any lawful act or activity for which corporations may be organized and incorporated under the General Corporation Law of the State of Delaware.

The Directors of Morgan Stanley as of the date of this Base Prospectus are the following: John J. Mack, Roy J. Bostock, Erskine B. Bowles, Sir Howard J. Davies, C. Robert Kidder, Donald T. Nicolaisen, Charles H. Noski, Hutham S. Olayan, Charles E. Phillips, O. Griffith Sexton, Dr. Laura D. Tyson and Dr. Klaus Zumwinkel.

As at 31 May 2006, Morgan Stanley had 53,163 worldwide employees.

The authorised share capital of Morgan Stanley as at 31 May 2006 comprised 3,500,000,000 ordinary shares of nominal value U.S.\$0.01.

For the year ended 30 November 2005, total assets of Morgan Stanley amounted to U.S.\$898,523 million and total liabilities and shareholders' equity amounted to U.S.\$898,523 million. For the fiscal year ended 30 November 2004, total assets of Morgan Stanley amounted to U.S.\$747,334 million and total liabilities and shareholders' equity amounted to U.S.\$747,334 million.

There are a number of factors which could cause Morgan Stanley's actual results to differ, in some instances materially, from those anticipated. The factors set out below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties which face Morgan Stanley's business.

The results of Morgan Stanley's operations may be materially affected by market fluctuations and by economic and other factors such as political, economic and market conditions, the availability and cost of capital, the level and volatility of equity prices, commodity prices and interest rates, currency values and other market indices, technological changes and events, the availability and cost of credit, inflation, and investor sentiment and confidence in the financial markets.

Morgan Stanley faces strong competition from other financial services firms, which could lead to pricing pressures that could materially adversely affect its revenue and profitability.

The financial services industry faces substantial litigation and regulatory risks, and Morgan Stanley may face damage to its professional reputation and legal liability if its services are not regarded as satisfactory or for other reasons.

#### *Morgan Stanley Jersey*

Morgan Stanley Jersey was incorporated in St. Helier, Jersey, Channel Islands (registration number 35857) as a company with unlimited duration on 24 September 1986. It has its registered office at 22 Grenville Street, St. Helier, Jersey JE4 8PX, Channel Islands. Morgan Stanley Jersey's objects and purposes are not specified in any document and are therefore unlimited.

Morgan Stanley Jersey's business primarily consists of issuing financial instruments and the hedging of obligations relating thereto. All material assets of Morgan Stanley Jersey are obligations of (or securities issued by) one or more Morgan Stanley group companies. Morgan Stanley Jersey's auditors are Deloitte & Touche, Chartered Accountants and Registered Auditors.

Morgan Stanley Jersey has no subsidiaries and is wholly owned by Morgan Stanley.

The directors of Morgan Stanley Jersey are Joel Hodes, Charles Edward Crossley Hood and John Roberts. Morgan Stanley Jersey has no employees.

The authorised share capital of Morgan Stanley Jersey comprises 10,000 ordinary shares of nominal value GBP1. The issued, allotted and fully paid up share capital of Morgan Stanley Jersey comprises 10,000 ordinary shares of nominal value GBP1.

The (loss) / profit before tax for the financial years ended 30 November 2005 and 2004 was nil and U.S.\$(16,000) respectively. The current assets of Morgan Stanley Jersey have fallen from U.S.\$4,758,540,000 in 2004 to U.S.\$3,598,223,000 in 2005 with total creditors falling from U.S.\$4,758,084,000 in 2004 to U.S.\$3,597,767,000 in 2005.

All material assets of Morgan Stanley Jersey are obligations of (or securities issued by) one or more Morgan Stanley group companies. The obligations of Morgan Stanley Jersey pursuant to such hedging transactions are guaranteed by

Morgan Stanley. If any of these Morgan Stanley group companies incur losses with respect to any of their activities (irrespective of whether those activities relate to Morgan Stanley Jersey or not) their ability to fulfil their obligations to Morgan Stanley Jersey could be impaired, thereby exposing holders of securities issued by Morgan Stanley Jersey to a risk of loss.

#### *MSBV*

MSBV was incorporated as a private company with limited liability under the laws of The Netherlands on 6 September 2001 for an unlimited duration. MSBV is registered at the commercial register of the Chamber of Commerce and Industries for Amsterdam under number 34161590. It has its corporate seat at Amsterdam and its offices are located at Locatellikade 1, 1076 AZ Amsterdam, The Netherlands. Telephone number +31 20 57 55 600.

MSBV's objects are, *inter alia*, to issue notes, warrants and other securities. All material assets of MSBV are obligations of (or securities issued by) one or more Morgan Stanley group companies. MSBV's auditors are Deloitte Accountants B.V. (members of the Royal Netherlands Institute of Registered Accountants).

MSBV has no subsidiaries and is ultimately controlled by Morgan Stanley.

The directors of MSBV are C.E.C Hood, J. Solan, G.C. De Boer and TMF Management B.V. MSBV has no employees.

The authorised share capital of MSBV comprises 900 ordinary shares of nominal value EUR100. The issued, allotted and fully paid up share capital of MSBV comprises 180 ordinary shares of nominal value EUR100.

MSBV's net revenue for the financial years ended 30 November 2005 and 2004 was EUR (1,614,000) and EUR 3,638,000, respectively, representing issuance fees received on the issuance of financial instruments less guarantee fees payable. The (loss)/profit before tax for the financial years ended 30 November 2005 and 2004 was EUR (1,475,000) and EUR3,660,000 respectively. During the period, no dividends were paid. The loss will be carried to reserves.

The current assets of MSBV rose from EUR 415,715,000 in 2004 to EUR 641,974,000 in 2005 with a total amount owing to creditors rising from EUR 126,158,000 to EUR 636,732,000 in 2005. The principal reason for the increase in debt was an increase in client demand for financial instruments.

All material assets of MSBV are obligations of (or securities issued by) one or more Morgan Stanley group companies. The obligations of MSBV pursuant to such transactions are substantially guaranteed by Morgan Stanley. If any of these Morgan Stanley group companies incur losses with respect to any of their activities (irrespective of whether those activities relate to MSBV or not) their ability to fulfil their obligations to MSBV could be impaired, thereby exposing holders of securities issued by MSBV to a risk of loss.

#### **Essential characteristics and risks associated with the Securities**

Morgan Stanley, Morgan Stanley Jersey and MSBV may offer from time to time Warrants and Certificates (together, "**Securities**"). Applications have been made for the Securities issued under the Program to be admitted to the Official List and to trading on the Irish Stock Exchange. The payment of all amounts due in respect of Securities issued by Morgan Stanley Jersey or MSBV will, unless specified otherwise in the Final Terms be unconditionally and irrevocably guaranteed by Morgan Stanley.

Each Issuer is offering the Securities on a continuing basis through the Distribution Agents, who have agreed to use reasonable efforts to solicit offers to purchase the Securities. Each Issuer may also sell Securities to the Distribution Agents as principal for their own accounts at a price to be agreed upon at the time of sale. The Distribution Agents

may resell any Securities they purchase as principal at prevailing market prices, or at other prices, as they determine. Each Issuer or the Distribution Agents may reject any offer to purchase Securities, in whole or in part.

Each Issuer will issue Securities in bearer form, which may be in either definitive form or global form. Securities in definitive bearer form will be serially numbered. Securities may be denominated or payable in any currency, be issued at any price and have any maturity, in each case subject to all applicable consents being obtained and compliance with all applicable legal and regulatory requirements.

Securities may be redeemed at par or at such other redemption amount (detailed in a formula or otherwise) or by delivery of securities of an issuer that is not affiliated with Morgan Stanley, as may be specified in the applicable Final Terms.

The Securities will be governed by, and construed in accordance with, the laws of England and Wales.

The net proceeds from the sale of Securities offered by the Base Prospectus will be used by the Issuers for general corporate purposes, in connection with hedging its obligations under the Securities, or both.

Certain documents relating to the Securities will be available, during usual business hours on any week day, for inspection by physical means at JPMorgan Chase Bank, N.A., Trinity Tower, 9 Thomas More Street, London E1W 1YT and at J.P. Morgan Bank (Ireland) plc, J.P. Morgan House, International Finance Service Centre, Dublin 1, Ireland Dublin and also at the principal executive offices of Morgan Stanley and the registered offices of Morgan Stanley Jersey and MSBV.

The Issuers may issue Securities with return determined by reference to currency prices, commodity prices or to single securities, baskets of securities or indices or other assets or instruments. Any such Securities may entail significant risks not associated with a similar investment in fixed or floating rate debt securities, including a return that may be significantly less than the return available on an investment in fixed or floating rate debt securities. In some cases such Securities may also carry the risk of a total or partial loss of investment.

## RISK FACTORS

*Prospective investors should read the entire Base Prospectus (and where appropriate, any relevant final prospectus) and the related offering memorandum. Words and expressions defined elsewhere in this Base Prospectus have the same meanings in this section. Investing in securities involves certain risks. Prospective investors should consider, among other things, the following:*

### **Risk Relating to Morgan Stanley**

**The results of Morgan Stanley's operations may be materially affected by market fluctuations and by economic and other factors.**

The results of Morgan Stanley's operations may be materially affected by market fluctuations and by economic and other factors. Results of operations in the past have been, and in the future may continue to be, materially affected by many factors of a global nature, including: political, economic and market conditions; the availability and cost of capital; the level and volatility of equity prices, commodity prices and interest rates; currency values and other market indices; technological changes and events; the availability and cost of credit; inflation; and investor sentiment and confidence in the financial markets. In addition, there have been legislative, legal and regulatory developments related to Morgan Stanley's businesses that potentially could increase costs, thereby affecting future results of operations. These factors also may have an impact on Morgan Stanley's ability to achieve its strategic objectives.

The results of Morgan Stanley's Institutional Securities business, particularly results relating to its involvement in primary and secondary markets for all types of financial products, are subject to substantial fluctuations due to a variety of factors that Morgan Stanley cannot control or predict with great certainty, including variations in the fair value of securities and other financial products and the volatility and liquidity of global markets. Fluctuations also occur due to the level of global market activity, which, among other things, affects the size, number, and timing of investment banking client assignments and transactions and the realization of returns from Morgan Stanley's principal investments.

During periods of unfavorable market or economic conditions, the level of individual investor participation in the global markets may also decrease, which would negatively impact the results of Morgan Stanley's Global Wealth Management Group. In addition, fluctuations in global market activity could impact the flow of investment capital into or from assets under management and supervision and the way customers allocate capital among money market, equity, fixed income or other investment alternatives, which could negatively impact Morgan Stanley's Investment Management business. Furthermore, changes in economic variables, such as the number and size of personal bankruptcy filings, the rate of unemployment, and the level of consumer confidence and consumer debt, may substantially affect consumer loan levels and credit quality, which, in turn, could impact the results of Morgan Stanley's Discover business.

**Liquidity is essential to Morgan Stanley's businesses and Morgan Stanley relies on external sources to finance a significant portion of its operations.**

**General.** Liquidity is essential to Morgan Stanley's businesses. Morgan Stanley's liquidity could be substantially negatively affected by an inability to raise funding in the long-term or short-term debt capital markets or an inability to access the secured lending markets. Factors that Morgan Stanley cannot control, such as disruption of the financial markets or negative views about the financial services industry generally, could impair its ability to raise funding. In addition, Morgan Stanley's ability to raise funding could be impaired if lenders develop a negative perception of its long-term or short-term financial prospects. Such negative perceptions could be developed if Morgan Stanley incurs large trading losses, it suffers a decline in the level of its business activity, regulatory authorities take significant action against it, or Morgan Stanley discovers serious employee misconduct or illegal activity, among other reasons. If Morgan Stanley is unable to raise funding using the methods described above, it would likely need to liquidate unencumbered assets, such as its investment and trading portfolios, to meet maturing

liabilities. Morgan Stanley may be unable to sell some of its assets, or it may have to sell assets at a discount from market value, either of which could adversely affect its results of operations.

**Credit Ratings.** The cost and availability of unsecured financing generally are dependent on Morgan Stanley's short-term and long-term credit ratings. Factors that are significant to the determination of Morgan Stanley's credit ratings or otherwise affect its ability to raise short-term and long-term financing include the level and volatility of its earnings; its relative competitive position in the markets in which Morgan Stanley operates; its geographic and product diversification; its ability to retain key personnel; its risk management policies; its cash liquidity; its capital adequacy; its corporate lending credit risk; and legal and regulatory developments. A deterioration in any of these factors or combination of these factors may lead rating agencies to downgrade Morgan Stanley's credit ratings, thereby increasing its cost of obtaining unsecured funding.

Morgan Stanley's debt ratings also can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as OTC derivative transactions, including credit derivatives and interest rate swaps. In connection with certain OTC trading agreements and certain other agreements associated with the Institutional Securities business, Morgan Stanley would be required to provide additional collateral to certain counterparties in the event of a downgrade by either Moody's Investors Service or Standard & Poor's.

**Payments From Subsidiaries.** Morgan Stanley depends on dividends, distributions and other payments from its subsidiaries to fund dividend payments and to fund all payments on its obligations, including debt obligations. Regulatory and other legal restrictions may limit Morgan Stanley's ability to transfer funds freely, either to or from its subsidiaries. In particular, many of Morgan Stanley's subsidiaries, including its broker-dealer subsidiaries, are subject to laws and regulations that authorize regulatory bodies to block or reduce the flow of funds to the parent holding company, or that prohibit such transfers altogether in certain circumstances. These laws and regulations may hinder Morgan Stanley's ability to access funds that it may need to make payments on its obligations.

**Liquidity and Funding Policies.** Morgan Stanley's liquidity and funding policies have been designed to ensure that it maintains sufficient liquid financial resources to continue to conduct its business for an extended period in a stressed liquidity environment. If Morgan Stanley's liquidity and funding policies are not adequate, it may be unable to access sufficient financing to service its financial obligations when they come due, which could have a material adverse franchise or business impact.

**Morgan Stanley is exposed to the risk that third parties that are indebted to it will not perform their obligations.**

Credit risk refers to the risk of loss arising from the default by a borrower, counterparty or other obligor when it is unable or unwilling to meet its obligations to Morgan Stanley. Morgan Stanley is exposed to three distinct types of credit risk in its businesses. Morgan Stanley incurs significant, "single-name" credit risk exposure through the Institutional Securities business. This risk may arise, for example, from entering into swap or other derivative contracts under which counterparties have long-term obligations to make payments to Morgan Stanley and by extending credit to its clients through various credit arrangements. Morgan Stanley incurs "individual consumer" credit risk in the Global Wealth Management Group business through margin loans to individual investors and loans to small businesses, both of which are generally collateralized. Morgan Stanley incurs "consumer portfolio" credit risk in the Discover business primarily through cardholder receivables. Credit risk in a pool of cardholder receivables is generally highly diversified, without significant individual exposures, and, accordingly, is managed on a portfolio and not a single-name basis.

The amount, duration and range of Morgan Stanley's credit exposures have been increasing over the past several years, and may continue to do so. In recent years, Morgan Stanley has significantly expanded its use of swaps and other derivatives and it may continue to do so. Corporate clients are increasingly seeking loans or lending

commitments from Morgan Stanley in connection with investment banking and other assignments. In addition, Morgan Stanley has experienced, due to competitive factors, increased pressure to assume longer-term credit risk, to extend credit against less liquid collateral and to price derivatives instruments more aggressively based on the credit risks that it takes. As a clearing member firm, Morgan Stanley finances its customer positions and it could be held responsible for the defaults or misconduct of its customers. Although Morgan Stanley regularly reviews its credit exposures, default risk may arise from events or circumstances that are difficult to detect or foresee.

**Morgan Stanley faces strong competition from other financial services firms, which could lead to pricing pressures that could materially adversely affect its revenue and profitability.**

The financial services industry, and all of Morgan Stanley's businesses, are intensely competitive, and Morgan Stanley expects them to remain so. Morgan Stanley competes with commercial banks, insurance companies, sponsors of mutual funds, hedge funds, energy companies and other companies offering financial services in the U.S., globally and through the Internet. Morgan Stanley competes on the basis of several factors, including transaction execution, capital or access to capital, its products and services, innovation, reputation and price. Over time, certain sectors of the financial services industry have become considerably more concentrated, as financial institutions involved in a broad range of financial services have been acquired by or merged into other firms. This convergence could result in Morgan Stanley's competitors gaining greater capital and other resources, such as a broader range of products and services and geographic diversity. Morgan Stanley may experience pricing pressures as a result of these factors and as some of its competitors seek to increase market share by reducing prices.

**Morgan Stanley's ability to retain and attract qualified employees is critical to the success of its business and the failure to do so may materially adversely affect its performance.**

Morgan Stanley's people are its most important resource and competition for qualified employees is intense. In order to attract and retain qualified employees, Morgan Stanley must compensate such employees at market levels. Typically, those levels have caused employee compensation to be Morgan Stanley's greatest expense as compensation is highly variable and moves with performance. If Morgan Stanley is unable to continue to attract and retain qualified employees, or if compensation costs required to attract and retain employees become more expensive, its performance, including its competitive position, could be materially adversely affected.

**Morgan Stanley is subject to extensive regulation in the jurisdictions in which it conducts its businesses.**

Morgan Stanley is subject to extensive regulation globally and faces the risk of significant intervention by regulatory authorities in the jurisdictions in which it conducts its businesses. Among other things, Morgan Stanley could be fined, prohibited from engaging in some of its business activities or subject to limitations or conditions on its business activities. Significant regulatory action against Morgan Stanley could have material adverse financial effects, cause significant reputational harm to it or harm its business prospects. New laws or regulations or changes in the enforcement of existing laws or regulations applicable to Morgan Stanley's clients may also adversely affect its business.

**The financial services industry faces substantial litigation and regulatory risks, and Morgan Stanley may face damage to its reputation and legal liability.**

Morgan Stanley 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.

Morgan Stanley is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding its 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 these investigations and proceedings has increased in recent years with regard to many firms in the financial services industry, including Morgan Stanley. Morgan Stanley is also subject to risk from potential employee misconduct, including non-compliance with policies and improper use or disclosure of confidential information. Substantial legal liability or significant regulatory action against Morgan Stanley could materially adversely affect its business, financial condition or results of operations or cause significant reputational harm to Morgan Stanley, which could seriously harm its business. For more information regarding legal proceedings in which Morgan Stanley and its subsidiaries are involved and in particular, the *Coleman Litigation*, see “Legal Proceedings” in Part I, Item 3 of Morgan Stanley’s Annual Report on Form 10-K for the fiscal year ended 30 November 2005 and Part II, Item 1 of Morgan Stanley’s Quarterly Reports on Form 10-Q for the quarterly periods ended 28 February 2006 and 31 May 2006, respectively.

**Conflicts of interest are increasing and a failure to appropriately deal with conflicts of interest could adversely affect Morgan Stanley's businesses.**

Morgan Stanley's reputation is one of its most important assets. As Morgan Stanley has expanded the scope of its businesses and its client base, it increasingly has to address potential conflicts of interest, including those relating to its proprietary activities. For example, conflicts may arise between Morgan Stanley's position as a financial advisor in a merger transaction and a principal investment it holds in one of the parties to the transaction. In addition, hedge funds and private equity funds are an increasingly important portion of Morgan Stanley's client base, and also compete with Morgan Stanley in a number of its businesses. Morgan Stanley has procedures and controls that are designed to address conflicts of interest. However, appropriately dealing with conflicts of interest is complex and difficult and Morgan Stanley's reputation could be damaged if it fails, or appears to fail, to deal appropriately with conflicts of interest. In addition, the United States Securities and Exchange Commission and other federal and state regulators have increased their scrutiny of potential conflicts of interest. It is possible that potential or perceived conflicts could give rise to litigation or enforcement actions. It is possible that the regulatory scrutiny of, and litigation in connection with, conflicts of interest will make Morgan Stanley's clients less willing to enter into transactions in which such a conflict may occur, and will adversely affect its businesses.

**Morgan Stanley is subject to tax contingencies that could adversely affect reserves.**

Morgan Stanley is subject to the income tax laws of the U.S., its states and municipalities and those of the foreign jurisdictions in which Morgan Stanley has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. Morgan Stanley must make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and must also make estimates about when in the future certain items affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit.

**Morgan Stanley is subject to operational risk and an operational failure could materially adversely affect its businesses.**

Operational risk refers to the risk of loss arising from inadequate or failed internal processes, people and/or systems. Operational Risk also refers to the risk that external events, such as external changes (e.g., natural disasters, terrorist attacks and/or health epidemics), failures or frauds, will result in losses to Morgan Stanley's businesses. Morgan Stanley incurs operational risk across all of its business activities, including revenue generating activities (e.g., such as sales and trading) and support functions (e.g., information technology and facilities management).

Morgan Stanley's businesses are highly dependent on its ability to process, on a daily basis, a large number of transactions across numerous and diverse markets in many currencies and the transactions Morgan Stanley processes have become increasingly complex. Morgan Stanley performs the functions required to operate its different

businesses either by itself or through agreements with third parties. Morgan Stanley relies on the ability of its employees, its internal systems and systems at technology centers operated by third parties to process high numbers of transactions. Morgan Stanley also faces the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries it uses to facilitate its securities transactions. In the event of a breakdown or improper operation of its or third-party's systems or improper action by third parties or employees, Morgan Stanley could suffer financial loss, an impairment to its liquidity, a disruption of its businesses, regulatory sanctions and damage to its reputation.

**Morgan Stanley's commodities activities subject it to extensive regulation, potential catastrophic events and environmental risks and regulation.**

In connection with the commodities activities in Morgan Stanley's Institutional Securities business, Morgan Stanley engages in the production, storage, transportation, marketing and trading of power, natural gas and petroleum. In addition, Morgan Stanley is the sole shareholder of wholesale electrical generators. As a result of these activities, Morgan Stanley is subject to extensive and evolving energy, environmental, safety and other governmental laws and regulations. Morgan Stanley's commodities business also exposes it to the risk of unforeseen and catastrophic events, including leaks, spills and terrorist attacks.

The power generation facilities in which Morgan Stanley is the sole shareholder are subject to wide-ranging U.S. federal, state and local environmental laws and regulations in the U.S. and abroad relating to air quality, water quality and hazardous and solid waste management. They also are regulated under U.S. health and safety regulations. These laws may require capital expenditures as well as remediation where the facility has failed to comply with environmental, health or safety rules or has released pollutants into the environment. Additionally, the owners of such facilities may be subject to fines or penalties for failure to comply with environmental, health or safety rules.

The U.S. water pollution laws and numerous specific oil spill anti-pollution statutes apply to Morgan Stanley's oil trading activities to the extent Morgan Stanley owns petroleum in storage or during waterborne or overland transit or it arranges for transportation or storage. In the event of an oil spill, one or more entities Morgan Stanley owns could be held responsible for remediation as well as property and natural resource damages. Other U.S. federal and state laws apply to the specifications of the gasoline and diesel fuel that Morgan Stanley blends and import and provide for substantial penalties in the event of non-compliance.

Oil pollution laws in non-U.S. jurisdictions also apply to Morgan Stanley in certain instances when it trades petroleum internationally and/or charter vessels. Like the U.S. statutes, these laws often provide for penalties and damage assessments should a spill event occur.

Although Morgan Stanley has attempted to mitigate its pollution and other environmental risks by, among other measures, adopting appropriate policies and procedures for power plant operations, monitoring the quality of petroleum storage facilities and transport vessels and implementing emergency response programs, these actions may not prove adequate to address every contingency. In addition, insurance covering some of these risks may not be available, and the proceeds from insurance recovery, if any, may not be adequate to cover liabilities with respect to particular incidents. As a result, Morgan Stanley's financial condition and results of operations may be adversely affected by these events.

Morgan Stanley also expects the other laws and regulations affecting its energy business to increase in both scope and complexity. During the past several years, intensified scrutiny of the energy markets by federal, state and local authorities in the U.S. and abroad and the public has resulted in increased regulatory and legal enforcement, litigation and remedial proceedings involving companies engaged in the activities in which Morgan Stanley is engaged. Morgan Stanley may incur substantial costs in complying with current or future laws and regulations and its overall businesses and reputation may be adversely affected by the current legal environment.

**Morgan Stanley is subject to numerous political, economic, legal, operational and other risks as a result of its international operations that could adversely affect its business in many ways.**

Morgan Stanley is subject to political, economic, legal, operational and other risks that are inherent in operating in many countries, including risks of possible nationalization, expropriation, price controls, capital controls, exchange controls and other restrictive governmental actions, as well as the outbreak of hostilities. In many countries, the laws and regulations applicable to the securities and financial services industries are uncertain and evolving, and it may be difficult for Morgan Stanley to determine the exact requirements of local laws in every market. Morgan Stanley's inability to remain in compliance with local laws in a particular market could have a significant and negative effect not only on its businesses in that market but also on its reputation generally. Morgan Stanley is also subject to the enhanced risk that transactions it structures might not be legally enforceable in all cases.

In the last several years, various emerging market countries have experienced severe economic and financial disruptions, including significant devaluations of their currencies, capital and currency exchange controls, and low or negative growth rates in their economies. These conditions could adversely impact Morgan Stanley's businesses and increase volatility in financial markets generally.

The emergence of a pandemic or other widespread health emergency, or concerns over the possibility of such an emergency, could create economic and financial disruptions in emerging markets and other areas throughout the world, and could lead to operational difficulties (including travel limitations) that could impair Morgan Stanley's ability to manage its businesses around the world.

**Morgan Stanley may be unable to fully integrate future acquisitions or joint ventures into its businesses and systems.**

Morgan Stanley expects to grow in part through acquisitions and joint ventures. To the extent Morgan Stanley makes acquisitions or enter into combinations or joint ventures, it faces numerous risks and uncertainties combining or integrating the relevant businesses and systems, including the need to combine accounting and data processing systems and management controls and to integrate relationships with clients and business partners. In the case of joint ventures, Morgan Stanley is subject to additional risks and uncertainties in that it may be dependent upon, and subject to liability, losses or reputational damage relating to, systems, controls and personnel that are not under its control. In addition, conflicts or disagreements between Morgan Stanley and its joint venture partners may negatively impact the benefits to be achieved by the joint venture.

**Morgan Stanley's Discover business subjects it to risks that impact the credit card industry.**

The performance of Morgan Stanley's Discover business is subject to numerous risks that impact the credit card industry, including rising cost of funds pressuring spreads; slow industry growth with rising payment rates; future loan loss rate uncertainty, especially given bankruptcy reform and changing minimum payment requirements; and a consolidating industry with competitive pressures and increasing marketing constraints. Changes in economic variables, such as the number and size of personal bankruptcy filings, the rate of unemployment and the level of consumer confidence and consumer debt may substantially affect consumer loan levels and credit quality. Morgan Stanley's financial condition and results of operations may be adversely affected by these factors.

**Risks relating to Morgan Stanley Jersey**

All material assets of Morgan Stanley Jersey are obligations of (or securities issued by) one or more Morgan Stanley group companies. The obligations of Morgan Stanley Jersey pursuant to such transactions are guaranteed by Morgan Stanley. If any of these Morgan Stanley group companies incur losses with respect to any of their activities (irrespective of whether those activities relate to Morgan Stanley Jersey or not) their ability to fulfil their obligations to Morgan Stanley Jersey could be impaired, thereby exposing holders of securities issued by Morgan Stanley Jersey to a risk of loss.

## **Risks relating to MSBV**

All material assets of MSBV are obligations of (or securities issued by) one or more Morgan Stanley group companies. The obligations of MSBV pursuant to such transactions are guaranteed by Morgan Stanley. If any of these Morgan Stanley group companies incur losses with respect to any of their activities (irrespective of whether those activities relate to MSBV or not) their ability to fulfil their obligations to MSBV could be impaired, thereby exposing holders of securities issued by MSBV to a risk of loss.

## **Risks relating to the Securities**

**Investors should consult their financial and legal advisors as to any specific risks entailed by an investment in Securities that are denominated or payable in, or the payment of which is linked to the value of, a currency other than the currency of the country in which such investor resides or in which such investor conducts its business, which is referred to as their "home currency." These Securities are not appropriate investments for investors who are not sophisticated in foreign currency transactions. The Issuers disclaim any responsibility to advise prospective purchasers of any matters arising under the laws of the country in which they reside that may affect the purchase of, or holding of, or the receipt of payments on the Securities. These persons should consult their own legal and financial advisors concerning these matters. Investors should also consult their financial and legal advisors as to risks entailed by an investment in Securities that are linked to currency prices, commodity prices, single securities, baskets of securities or indices.**

A wide range of Securities may be issued under the Program. A number of these Securities may have features which contain particular risks for potential investors. Set out below is a description of the most common features of such Securities:

### ***Index Linked Securities and Dual Currency Securities***

The Issuer may issue Securities with return determined by reference to an index or formula, to changes in the price of securities or commodities, to movements in currency exchange rates or other factors (each, a "**Relevant Factor**"). In addition, the Issuer may issue Securities payable in one or more currencies which may be different from the currency in which the Securities are denominated. Potential investors should be aware that:

- (i) the market price of such Securities may be very volatile;
- (ii) payment may occur at a different time or in a different currency than expected;
- (iii) they may lose all or a substantial portion of their investment;
- (iv) a Relevant Factor may be subject to significant fluctuations that may not correlate with changes in currencies or other indices;
- (v) if a Relevant Factor is applied to Securities in conjunction with a multiplier greater than one or contains some other leverage factor, the effect of changes in the Relevant Factor on such Securities is likely to be magnified; and
- (vi) the timing of changes in a Relevant Factor may affect the actual yield to investors, even if the average level is consistent with their expectations. In general, the earlier the change in the Relevant factor, the greater the effect on yield.

### ***Securities Are Not Ordinary Debt Securities***

The terms of Securities differ from those of ordinary debt securities because such Securities do not pay interest at maturity may return less than the amount invested or nothing, or may return securities of an issuer that is affiliated with Morgan Stanley, Morgan Stanley Jersey or MSBV, the value of which is less than the amount invested, depending on the performance of the underlying asset. Prospective investors who consider purchasing Securities should reach an investment decision only after carefully considering the suitability of the Securities in light of their particular circumstances. The price of Securities may fall in value as rapidly as it may rise, and investors in Securities will sustain a total loss of their investment if the Securities expire out of the money.

### ***The Value of Securities Linked to Single Securities, Baskets of Securities or Indices May Be Influenced by Unpredictable Factors***

The value of the Securities may be influenced by several factors beyond the relevant Issuer's and, where applicable, the Guarantor's control, including: (i) the market price or value of the applicable underlying security, basket of securities or index, (ii) the volatility (frequency and magnitude of changes in price) of the underlying security, basket of securities or index, (iii) the dividend rate on any underlying securities, (iv) economic, financial and political events that affect stock markets generally and which may affect the market price of the underlying security, basket of securities or index, (v) interest and yield rates in the market, (vi) the time remaining to the maturity of the Securities and (vii) the relevant Issuer's and, where applicable, the Guarantor's creditworthiness.

Some or all of these factors will influence the price investors will receive if an investor sells its Securities prior to maturity. For example, investors may have to sell certain Securities at a substantial discount from the amount invested if the market price or value of the applicable underlying security, basket of securities or index is at, below, or not sufficiently above the initial market price or value or if market interest rates rise.

### ***No Affiliation with Underlying Companies***

The underlying issuer for any single security or basket security or the publisher of an underlying index will not be an affiliate of Morgan Stanley, Morgan Stanley Jersey or MSBV, unless otherwise specified in the applicable Final Terms. Morgan Stanley or its subsidiaries may presently or from time to time engage in business with any underlying company, or any specified entity, including entering into loans with, or making equity investments in, the underlying company, or specified entity, or its affiliates or subsidiaries or providing investment advisory services to the underlying company, or specified entity, including merger and acquisition advisory services. Moreover, no Issuer has the ability to control or predict the actions of the underlying company, index publisher, or specified entity, including any actions, or reconstitution of index components, of the type that would require the determination agent to adjust the payout to the investor at maturity. No underlying company, index publisher, or specified entity, for any issuance of Securities is involved in the offering of the Securities in any way or has any obligation to consider the investor's interest as an owner of the Securities in taking any corporate actions that might affect the value of the Securities. None of the money an investor pays for the Securities will go to the underlying company, or specified entity, for such Securities.

### ***Secondary Trading of the Securities May Be Limited***

There may be little or no secondary market for the Securities. Although an Issuer may apply to have certain issuances of Securities admitted to the Official List and to trading on the Irish Stock Exchange or admitted to listing, trading and/or quotation by any other listing authority, stock exchange and/or quotation system, approval for any listing is subject to meeting the relevant listing requirements. Even if there is a secondary market, it may not provide enough liquidity to allow the investor to sell or trade the Securities easily. Morgan Stanley & Co. International Limited currently intends to, and other affiliates of Morgan Stanley may from time to time, act as a market maker for the Securities, but they are not required to do so.

### ***Investors Have No Shareholder Rights***

As an owner of Securities, investors will not have voting rights or rights to receive dividends, interest or other distributions, as applicable, or any other rights with respect to any underlying security or index.

### ***Exchange Rates and Exchange Controls May Affect Securities' Value or Return***

*General Exchange Rate and Exchange Control Risks.* An investment in a Security denominated in, or the payment of which is linked to the value of, currencies other than the investor's home currency entails significant risks. These risks include the possibility of significant changes in rates of exchange between its home currency and the other relevant currencies and the possibility of the imposition or modification of exchange controls by the relevant governmental authorities. These risks generally depend on economic and political events over which the Issuers have no control.

*Exchange Rates Will Affect the Investor's Investment.* In recent years, rates of exchange between some currencies have been highly volatile and this volatility may continue in the future. Fluctuations in any particular exchange rate that have occurred in the past are not necessarily indicative, however, of fluctuations that may occur during the term of any Security. Depreciation against the investor's home currency or the currency in which a Security is payable would result in a decrease in the effective yield of the Security and could result in an overall loss to an investor on the basis of the investor's home currency. In addition, depending on the specific terms of a Security, changes in exchange rates relating to any of the relevant currencies could result in a decrease in its effective yield and in the investor's loss of all or a substantial portion of the value of that Security.

*The Issuers Have No Control Over Exchange Rates.* Currency exchange rates can either float or be fixed. Exchange rates of most economically developed nations are permitted to fluctuate in value relative to each other. However, from time to time governments may use a variety of techniques, such as intervention by a country's central bank, the imposition of regulatory controls or taxes, or changes in interest rate to influence the exchange rates of their currencies. Governments may also issue a new currency to replace an existing currency or alter the exchange rate or relative exchange characteristics by a devaluation or revaluation of a currency. These governmental actions could change or interfere with currency valuations and currency fluctuations that would otherwise occur in response to economic forces, as well as in response to the movement of currencies across borders.

As a consequence, these government actions could adversely affect yields or payouts in the investor's home currency for (i) Securities denominated or payable in currencies other than U.S. dollars and (ii) Currency-Linked Securities.

The Issuers will not make any adjustment or change in the terms of the Securities in the event that exchange rates should become fixed, or in the event of any devaluation or revaluation or imposition of exchange or other regulatory controls or taxes, or in the event of other developments affecting any currency. The investor will bear those risks.

*Some Currencies May Become Unavailable.* Governments have imposed from time to time, and may in the future impose, exchange controls that could also affect the availability of a Specified Currency (as defined herein). Even if there are no actual exchange controls, it is possible that the applicable currency for any security would not be available when payments on that security are due.

*Currency Exchange Information Will Be Provided in the Final Terms.* The applicable Final Terms or base prospectus supplement, where relevant, will include information with respect to any relevant exchange controls and any relevant historic exchange rate information for any Security. The investor should not assume that any historic information concerning currency exchange rates will be representative of the range of, or trends in, fluctuations in currency exchange rates that may occur in the future.

### ***Currency Exchange Conversions May Affect Payments on Some Securities***

The applicable Final Terms may provide for (i) payments on a non-U.S. dollar denominated Security to be made in U.S. dollars or (ii) payments in respect of Securities to be made in a currency other than U.S. dollars. In these cases, Morgan Stanley & Co. International Limited, in its capacity as Exchange Rate Agent (the "**Exchange Rate Agent**"), or such other exchange rate agent identified in the applicable Final Terms, will convert the applicable currency into U.S. dollars or U.S. dollars into the applicable currency. The investor will bear the costs of the conversion through deductions from those payments.

### ***Potential Conflicts of Interest Between the Investor and the Determination Agent***

As determination agent for Securities linked to single securities, baskets of securities or indices or other underlying instruments, assets or obligations, Morgan Stanley & Co. International Limited will determine the payout to the investor at maturity. Morgan Stanley & Co. International Limited and other affiliates may also carry out hedging activities related to any Securities linked to single securities, baskets of securities or indices or to other instruments, assets or obligations including trading in the underlying securities or indices as well as in other instruments related to the underlying securities or indices. Morgan Stanley & Co. International Limited and some of Morgan Stanley's other subsidiaries may also trade the applicable underlying securities or indices and other financial instruments related to the underlying securities or indices on a regular basis as part of their general broker-dealer and other businesses. Any of these activities could influence Morgan Stanley & Co. International Limited's determination of adjustments made to any Securities linked to single securities, baskets of securities or indices or other underlying instruments, assets or obligations and any such trading activity could potentially affect the price of the underlying securities or indices or other underlying instruments, assets or obligations and, accordingly, could affect the investor's payout on any Securities.

### **Risks relating to Securities generally**

***Because the Global Warrants (as defined below) may be held by or on behalf of Euroclear Bank S.A./N.V. as operator of the Euroclear System ("Euroclear") and Clearstream Banking, société anonyme ("Clearstream, Luxembourg"), investors will have to rely on their procedures for transfer, payment and communication with the relevant Issuer.***

Securities issued under the Program may be represented by one or more Global Warrants (each, a "**Global Warrant**"). Such Global Warrants may be deposited with a common depository for Euroclear and Clearstream, Luxembourg. Except in the circumstances described in the relevant Global Warrant, investors will not be entitled to receive definitive Securities. Euroclear and Clearstream, Luxembourg will maintain records of the beneficial interests in the Global Warrants. While the Securities are represented by one or more Global Warrants held by Euroclear or Clearstream, Luxembourg, investors will be able to trade their beneficial interests only through Euroclear or Clearstream, Luxembourg.

While the Securities are represented by one or more Global Warrant, the Issuer will discharge its payment obligations under the Securities by making payments to the common depository for Euroclear and Clearstream, Luxembourg for distribution to their account holders. A holder of a beneficial interest in a Global Warrant must rely on the procedures of Euroclear and Clearstream, Luxembourg to receive payments under the relevant Securities. Neither the relevant Issuer nor the Guarantor has responsibility or liability for the records relating to, or payments made in respect of, beneficial interests in the Global Warrants.

Holders of beneficial interests in the Global Warrants will not have a direct right to vote in respect of the relevant Securities. Instead, such holders will be permitted to act only to the extent that they are enabled by Euroclear, Clearstream, Luxembourg to appoint appropriate proxies.

***Modification and waiver***

The conditions of the Securities contain provisions for calling meetings of Securityholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Securityholders including Securityholders who did not attend and vote at the relevant meeting and Securityholders who voted in a manner contrary to the majority.

***Change of law***

The conditions of the Securities are based on English law in effect as at the date of this Base Prospectus. No assurance can be given as to the impact of any possible judicial decision or change to English law or administrative practice in England after the date of this Base Prospectus.

## WHERE THE INVESTOR CAN FIND MORE INFORMATION ABOUT MORGAN STANLEY

Morgan Stanley files annual, quarterly and current reports, proxy statements and other information with the United States Securities and Exchange Commission ("SEC"). The investor may read and copy any of these documents at the SEC's public reference room at Room 1580, 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. In addition, the SEC maintains a website that contains annual, quarterly and current reports, proxy statements and other information that Morgan Stanley files electronically. The address of the SEC's website is <http://www.sec.gov>. The information contained on this website, and any information available at the SEC's public reference room, shall not form part of this Base Prospectus, unless such information has been expressly incorporated herein by way of a supplement to this Base Prospectus.

Morgan Stanley's common stock, par value \$0.01 per share, is listed on the New York Stock Exchange, Inc. and the Pacific Exchange, Inc. under the symbol "MS." The investor may inspect annual, quarterly and current reports, proxy statements and other information concerning Morgan Stanley and its consolidated subsidiaries at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005, and the Pacific Exchange, Inc., 115 Sansome Street, San Francisco, California 94104 (such annual, quarterly and current reports, proxy statements and other information shall not form a part of this Base Prospectus unless they have been expressly incorporated herein by way of a supplement to this Base Prospectus).

## INCORPORATION BY REFERENCE

The following documents shall be deemed to be incorporated in, and to form part of, this Base Prospectus, to the extent that, on or before the date of this Base Prospectus, they have been published and filed with the IFSRA in its capacity as competent authority for the purposes of the Prospectus Directive and the relevant implementing measures in the Republic of Ireland:

- (i) Morgan Stanley's Quarterly Report on Form 10-Q for the quarterly period ended 28 February 2006 (as set out at <http://www.sec.gov>);
- (ii) Morgan Stanley's Proxy Statement dated 24 February 2006 (as set out at <http://www.sec.gov>);
- (iii) Morgan Stanley's Current Report on Form 8-K dated 22 February 2006 (as set out at <http://www.sec.gov>);
- (iv) Morgan Stanley's Annual Report on Form 10-K for year ended 30 November 2005 (as set out at <http://www.sec.gov>);
- (v) Morgan Stanley's Annual Report on Form 10-K for year ended 30 November 2004 (as set out at <http://www.sec.gov>);
- (vi) Morgan Stanley Jersey's Annual Report for year ended 30 November 2004; and
- (vii) MSBV's Annual Report for year ended 30 November 2004;

save that any statement contained in this Base Prospectus or any documents incorporated by reference herein, shall be deemed to be modified or superseded for the purpose of this Base Prospectus to the extent that a statement contained in any document subsequently incorporated by reference and in respect of which a supplement to this Base Prospectus is prepared modifies or supersedes such statement.

The information about Morgan Stanley, Morgan Stanley Jersey and MSBV incorporated by reference in this Base Prospectus, together with Morgan Stanley's Quarterly Report for the quarterly period ended 31 May 2006 which is set out in Annex C of this Base Prospectus, (the "**Incorporated Information**") is considered to be part of this Base Prospectus. Because future filings of Morgan Stanley with the SEC and future financial statements published by Morgan Stanley Jersey and MSBV are made from time to time, those future filings or financial statements, as the

case may be, may modify or supersede some of the information included or incorporated by reference in this Base Prospectus. This means that investors should look at all of the SEC filings of Morgan Stanley and all of the financial statements of Morgan Stanley Jersey and MSBV to determine if any of the statements in this Base Prospectus or in any document previously incorporated by reference have been modified or superseded.

The Issuers will, at their registered offices and at the specified offices of the Securities Agents, make available for inspection during normal business hours and free of charge, upon oral or written request, a copy of this Base Prospectus (or any document incorporated by reference in this Base Prospectus and any future filings or financial statements published such Issuer). Written or oral requests for inspection of such documents should be directed to the specified office of any Securities Agent.

## MORGAN STANLEY

### **Auditors**

The auditors of Morgan Stanley for the periods 1 December 2002 to 30 November 2003, 1 December 2003 to 30 November 2004, and 1 December 2004 to 30 November 2005 were Deloitte & Touche LLP, Two World Financial Center, New York, New York 10281, USA, an independent registered public accounting firm (the "**Auditors**").

The Auditors are registered with the Public Company Accounting Oversight Board (United States).

### **Risk Factors**

Information about risk factors relating to Morgan Stanley is contained in "Risk Factors" in this Base Prospectus.

### **Information about Morgan Stanley**

#### *History and Development of Morgan Stanley*

Morgan Stanley was originally incorporated for an unlimited term under the laws of the State of Delaware on 1 October 1981 under registered number 0923632, and its predecessor companies date back to 1924. On 31 May 1997, Morgan Stanley Group, Inc. was merged with and into Dean Witter Discover & Co. ("**Dean Witter Discover**") in a merger of equals. At that time, Dean Witter Discover changed its corporate name to Morgan Stanley, Dean Witter, Discover & Co. ("**MSDWD**"). On 24 March 1998 MSDWD changed its corporate name to Morgan Stanley Dean Witter & Co, and to Morgan Stanley on 20 June 2002. It has its registered office at The Corporation Trust Center, 1209 Orange Street, Wilmington, Delaware 19801, U.S.A., and its principal executive offices at 1585 Broadway, New York, New York 10036, U.S.A., telephone number +1 (212) 761-4000.

As at the date of this Base Prospectus, Morgan Stanley's legal and commercial name is "Morgan Stanley".

#### *Legislation*

Morgan Stanley is subject both to the laws of the United States of America and to the General Corporation Law of the State of Delaware ("**DGCL**"). United States federal laws affect many aspects of corporate affairs in the United States and concern such diverse matters as antitrust, bankruptcy, labor-management relations, the sale of securities and taxation. Certain United States federal securities laws are administered by the SEC and generally prohibit the sale of securities by fraudulent means and require most corporations that have issued securities, which are publicly held, such as Morgan Stanley, to make periodic financial and other reports to the SEC and to shareholders.

In the United States, business corporations are generally incorporated under the laws of one of the states. Morgan Stanley is incorporated under the laws of the State of Delaware.

Effective 1 December 2005, Morgan Stanley became a consolidated supervised entity (a "**CSE**") as defined by the SEC. As such, Morgan Stanley is subject to group-wide supervision and examination by the SEC and to minimum capital requirements on a consolidated basis. As of 31 May 2006, Morgan Stanley was in compliance with the CSE capital requirements.

Morgan Stanley & Co., one of Morgan Stanley's U.S. broker-dealers, is required to hold tentative net capital in excess of U.S.\$1 billion and net capital in excess of U.S.\$500 million in accordance with the market and credit risk standards of Appendix E of Rule 15c3-1. Morgan Stanley & Co. is also required to notify the SEC in the event that its tentative net capital is less than U.S.\$5 billion. As of 31 May 2006, Morgan Stanley & Co. had tentative net capital in excess of the minimum and the notification requirements.

Morgan Stanley continues to work with its regulators on the implementation of the CSE rules and the standards of the Basel Committee on Banking Supervision ("**Basel II**"). As rules related to Basel II are released, Morgan Stanley

will consult with regulators on the new requirements. Compliance with related EU requirements (capital, oversight and reporting) will be a focus item through 2008.

#### *Recent events*

Other than as disclosed in the Incorporated Information, no recent event particular to Morgan Stanley has occurred which is to a material extent relevant to the evaluation of its solvency.

#### *Investments*

On 17 February 2006, Morgan Stanley completed the acquisition of the Goldfish credit card business (“**Goldfish**”) in the U.K. from Lloyds TSB for approximately U.S.\$1,676 million. The acquisition of Goldfish added approximately 800,000 accounts and approximately U.S.\$1,316 million of receivables to Morgan Stanley’s existing U.K. credit card business. Since the acquisition date, the results of Goldfish have been included within the Discover business segment. Morgan Stanley recorded goodwill and other intangible assets of approximately U.S.\$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.

Except as disclosed herein and in the Incorporated Information, so far as Morgan Stanley is aware, there have been no material investments made since the date of its last published financial statements and there are no principal future investments to which Morgan Stanley’s management have already made firm commitments.

### **Business Overview**

#### *Principal Activities*

Morgan Stanley 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. Morgan Stanley, 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 Morgan Stanley’s representatives; a non-proprietary channel consisting of third-party broker-dealers, banks, financial planners and other intermediaries; Morgan Stanley’s institutional sales channel; and engages in investment activities.

*Discover* offers Discover<sup>®</sup>-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.

### *Principal Markets*

Morgan Stanley conducts its business from its headquarters in New York City, its regional offices and branches throughout the U.S. and its principal offices in London, Tokyo, Hong Kong and other world financial centers.

All aspects of Morgan Stanley's businesses are highly competitive and Morgan Stanley expects them to remain so. Morgan Stanley competes in the U.S. and globally for clients, market share and human talent in all aspects of its business segments. Morgan Stanley's competitive position depends on its reputation, the quality of its products, services and advice. Morgan Stanley's ability to sustain or improve its competitive position also depends substantially on its ability to continue to attract and retain qualified employees while managing compensation costs.

*Institutional Securities and Global Wealth Management Group:* Morgan Stanley's competitive position depends on innovation, execution capability and relative pricing. Morgan Stanley competes directly in the U.S. and globally with other securities and financial services firms, brokers and dealers, and with others on a regional or product basis. Morgan Stanley competes with commercial banks, insurance companies, sponsors of mutual funds, hedge funds, energy companies and other companies offering financial services in the U.S., globally and through the Internet.

Morgan Stanley's ability to access capital at competitive rates (which is generally dependent on Morgan Stanley's credit ratings) and to commit capital efficiently, particularly in its capital-intensive underwriting and sales, trading, financing and market-making activities, also affects its competitive position. Corporate clients continue to request that Morgan Stanley provide loans or lending commitments in connection with certain investment banking activities and Morgan Stanley expects this activity to continue in the future.

Over time, certain sectors of the financial services industry have become considerably more concentrated, as financial institutions involved in a broad range of financial services industries have been acquired by or merged into other firms. This convergence could result in Morgan Stanley's competitors gaining greater capital and other resources, such as a broader range of products and services and geographic diversity. It is possible that competition may become even more intense as Morgan Stanley continues to compete with financial institutions that may be larger, or better capitalized, or may have a stronger local presence and longer operating history in certain areas. Many of these firms have greater capital than Morgan Stanley and have the ability to offer a wide range of products that may enhance their competitive position and could result in pricing pressure in Morgan Stanley's businesses. The complementary trends in the financial services industry of consolidation and globalization present, among other things, technological, risk management, regulatory and other infrastructure challenges that require effective resource allocation in order for Morgan Stanley to remain competitive.

Morgan Stanley has experienced intense price competition in some of its businesses in recent years. In particular, the ability to execute trades electronically through the internet and other alternative trading systems has increased the pressure on trading commissions. The trend toward the use of alternative trading systems will likely continue. It is possible that Morgan Stanley will experience competitive pressures in these and other areas in the future as some of its competitors may seek to obtain market share by reducing prices.

*Asset Management:* Competition in the asset management industry is affected by several factors, including Morgan Stanley's reputation, investment objectives, quality of investment professionals, performance of investment products relative to peers and an appropriate benchmark index, advertising and sales promotion efforts, fee levels, the effectiveness of and access to distribution channels, and the types and quality of products offered. Morgan Stanley's products compete with the funds and separately managed account products of other asset management firms and other investment alternatives, including hedge funds.

*Discover:* Discover competes directly with other bank-issued credit cards (the vast majority of which bear the MasterCard or Visa servicemark), charge cards, credit cards issued by travel and financial advisory companies and debit cards. Credit cards that may be issued on the Discover Network by other financial institutions may also compete with credit cards offered by Discover through Discover Bank. Competition centers on merchant acceptance of credit and debit cards, account acquisition and customer utilization of credit and debit cards. Merchant acceptance is based on competitive transaction pricing and the volume and usage of cards in circulation. Credit card account acquisition and customer utilization are driven by competitive and appealing credit card features, such as no annual fees, low introductory interest rates and other customized features targeting specific consumer groups. Credit card industry participants have increasingly used advertising, targeted marketing, account acquisitions and pricing competition in interest rates, annual fees, reward programs and low-priced balance transfer programs to compete and grow.

The Discover Network competes with other card networks, including among others, VISA, MasterCard and American Express. The principal competitive factors that affect the network business include the number of cards in force and amount of spending on these cards, the quantity and quality of places where cards can be used, the economic attractiveness to card issuers and merchants participating in the network, reputation and brand recognition, innovation in systems, technology and product offerings, and quality of customer service.

### **Organisational Structure**

Morgan Stanley is a holding company that provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals, through its subsidiaries and affiliates.

Morgan Stanley's U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated, Morgan Stanley & Co. International Limited, Morgan Stanley Japan Limited, Morgan Stanley DW Inc., Morgan Stanley Investment Advisors Inc. and NOVUS Credit Services Inc.

### **Trend Information**

There has been no significant change in the financial or trading position of Morgan Stanley and its consolidated subsidiaries since 31 May 2006.

## Management

### *Directors*

The directors of Morgan Stanley as of the date of this Base Prospectus, their offices, if any, within Morgan Stanley, and their principal outside activity, if any, are listed below. The business address of each director is 1585 Broadway, New York, New York 10036, USA.

<b>Name</b>	<b>Function within Morgan Stanley</b>	<b>Principal Outside Activity</b>
John J. Mack	Chairman of the Board and Chief Executive Officer	John J. Mack does not perform other relevant managerial activities outside Morgan Stanley
Roy J. Bostock	Director	Director of Northwest Airlines Corporation and Yahoo! Inc.
Erskine B. Bowles	Director	President of the University of North Carolina, Director of General Motors Corporation and Cousins Properties Inc.
Sir Howard J. Davies	Director	Director of the London School of Economics and Political Science
C. Robert Kidder	Lead Director	Principal of Stonehenge Partners, Inc., Director of Schering-Plough Corporation
Donald T. Nicolaisen	Director	Director of Verizon Communications Inc.
Charles H. Noski	Director	Director of Microsoft Corporation and Air Products and Chemicals Inc.
Hutham S. Olayan	Director	President, Chief Executive Officer and Director of Olayan America Corporation, the Americas-based arm of The Olayan Group (since 1985). Director of the Olayan Group.
Charles E. Phillips	Director	President of Oracle Corporation, Director of Viacom, Inc.
O. Griffith Sexton	Director	Adjunct Professor at Columbia Business School and visiting lecturer at Princeton University, Advisory director of Morgan Stanley, Director of Investor AB

<b>Name</b>	<b>Function within Morgan Stanley</b>	<b>Principal Outside Activity</b>
Dr. Laura D. Tyson	Director	Dean of the London Business School, Director of Eastman Kodak Company and AT&T Inc.
Dr. Klaus Zumwinkel	Director	Chairman of the Board of Management, Deutsche Post AG, Director of Deutsche Lufthansa AG (Supervisory Board), Deutsche Telekom AG (Chairman, Supervisory Board), Karstadt Quelle AG (Supervisory Board) and Deutsche Postbank AG (Chairman, Supervisory Board)

### **Related Party Transactions**

During fiscal year 2005, Morgan Stanley's subsidiaries extended credit in the ordinary course of business to certain of Morgan Stanley's directors, officers and employees and members of their immediate families. These extensions of credit were in connection with margin loans, mortgage loans, credit card transactions, revolving lines of credit and other extensions of credit by Morgan Stanley's subsidiaries. The extensions of credit were made on substantially the same terms, including interest rates and collateral requirements, as those prevailing at the time for comparable transactions with other persons. The extensions did not involve more than the normal risk of collectability or present other unfavorable features. Directors, officers and employees and members of their immediate families who wish to purchase securities and derivative and financial products and financial services may do so through Morgan Stanley's subsidiaries. These subsidiaries may offer them discounts on their standard commission rates or fees. These subsidiaries also, from time to time and in the ordinary course of their business, enter into transactions on a principal basis involving the purchase or sale of securities and derivative products in which Morgan Stanley's directors, officers and employees and members of their immediate families have an interest. These purchases and sales may be made at a discount from the dealer mark-up or mark-down, as the case may be, charged to non-affiliated third parties. Certain employees, including Morgan Stanley's executive officers, may invest on the same terms and conditions as other investors in investment funds that Morgan Stanley may form and manage primarily for client investment, except that Morgan Stanley may waive or lower certain fees and expenses for its employees. In addition, Morgan Stanley may, pursuant to stock repurchase authorizations in effect from time to time, repurchase or acquire shares of Morgan Stanley's common stock in the open market or in privately negotiated transactions, which may include transactions with directors, officers and employees. These transactions are in the ordinary course of business and at prevailing market prices.

During fiscal 2005, Morgan Stanley engaged in transactions in the ordinary course of business with each of State Street and Barclays and certain of their respective affiliates. Each of State Street and Barclays beneficially owned more than 5% of the outstanding shares of Morgan Stanley common stock as of December 31, 2005. Such transactions were on substantially the same terms as those prevailing at the time for comparable transactions with unrelated third parties. Morgan Stanley also engages in transactions, including entering into financial services transactions (e.g., trading in securities, commodities or derivatives) with, and perform investment banking, financial advisory, brokerage, investment management and other services for, entities for which the directors and members of their immediate family serve as executive officers, and may make loans or commitments to extend loans to such entities. The transactions are conducted, services are performed, and loans and commitments are made in the

ordinary course of business and on substantially the same terms, including interest rate and collateral, that prevail at the time for comparable transactions with other persons. The loans do not involve more than the normal risk of collectability or present other unfavourable features.

There are no existing or potential conflicts of interest between any duties owed to Morgan Stanley by its directors or by the members of its principal committees and the private interests and/or other external duties owed by these individuals.

**Board Practice**

Morgan Stanley considers itself to be in compliance with all United States laws relating to corporate governance that are applicable to it.

The Board meets regularly and directors receive information between meetings about the activities of committees and developments in Morgan Stanley's business. All directors have full and timely access to all relevant information and may take independent professional advice if necessary.

The Corporate Governance Policies (including Morgan Stanley's standards of director independence), Code of Ethics and Business Conduct, Board Committee charters, Policy regarding Communication by Shareholders and other Interested Parties with the Board of Directors, Policy regarding Director Candidates Recommended by Shareholders, Policy regarding Corporate Political Contributions, Procedures for Reporting, Auditing and Accounting Concerns and the Management Committee Equity Ownership Commitment are available at Morgan Stanley's corporate governance webpage at the "Inside the Company" link under the "About Morgan Stanley" link at "<http://www.morganstanley.com/about/inside/governance>". The information contained on this webpage, shall not form part of this Base Prospectus, unless such information has been expressly incorporated herein by way of a supplement to this Base Prospectus.

The Board's standing committees include the following:

<b>Committee</b>	<b>Current Members</b>	<b>Primary Responsibilities</b>
Audit	Charles H. Noski (Chair)  Sir Howard J. Davies  Donald T. Nicolaisen	Oversees the integrity of Morgan Stanley's consolidated financial statements, system of internal controls, system of risk management and system of compliance with legal and regulatory requirements.  Selects, determines the compensation of, evaluates and, when appropriate, replaces the independent auditor, and pre-approves audit and permitted non-audit services.  Oversees the qualifications and independence of the independent auditor and performance of Morgan Stanley's internal and independent auditors.
Compensation,  Management,  Development and	C. Robert Kidder (Chair)  Erskine B. Bowles	Annually reviews and approves the corporate goals and objectives relevant to the compensation of the Chairman and CEO and evaluates his performance in light of

Committee	Current Members	Primary Responsibilities
Succession		<p>these goals and objectives.</p> <p>Determines the compensation of Morgan Stanley's executive officers and other appropriate officers.</p> <p>Administers Morgan Stanley's incentive and equity-based compensation plans.</p> <p>Oversees plans for management development and succession</p>
Nominating and Governance	<p>Dr. Laura D. Tyson (Chair)</p> <p>Roy J. Bostock</p> <p>Hutham S. Olayan</p> <p>Dr. Klaus Zumwinkel</p>	<p>Identifies and recommends candidates for election to the Board.</p> <p>Establishes procedures for its oversight of the evaluation of the Board and management.</p> <p>Recommends director compensation and benefits.</p> <p>Reviews annually Morgan Stanley's corporate governance policies.</p> <p>Assists in monitoring Morgan Stanley's compliance with legal and regulatory requirements.</p>

### *Employees*

As at 31 May 2006, Morgan Stanley had 53,163 employees worldwide.

## Principal Shareholders

Under SEC regulations applicable to Morgan Stanley, the relevant threshold for disclosure obligation concerning participation interests in listed companies is 5 per cent. of share capital. Therefore, this is the only information available to the public.

Morgan Stanley does not have information about shareholders with participation interests between 2 per cent. and 5 per cent. According to the most recent SEC filings, as at 24 February 2006, the following shareholders owned more than 5 per cent. of Morgan Stanley's common stock:

Name and Address	Shares of Common Stock Beneficially Owned	
	Number	per cent.(1)
State Street Bank and Trust Company(2) 225 Franklin Street, Boston, MA 02110	88,782,390	8.3%
Barclays Global Investors, N.A., and other reporting entities(3) 45 Fremont Street, San Francisco, CA 94105	64,581,639	6.0%

(1) Percentages calculated based upon common stock outstanding as of February 3, 2006 and holdings of common stock set forth in the Schedule 13G Information Statements described in notes 2-3 below. These Information Statements state that State Street and Barclays beneficially owned 8.4% and 6.1%, respectively, of Morgan Stanley's common stock on December 31, 2005.

(2) Based on Schedule 13G Information Statement filed February 14, 2006 by State Street, acting in various fiduciary capacities. The Schedule 13G discloses that State Street had sole voting power as to 29,244,065 shares, shared voting power as to 59,538,325 shares, sole dispositive power as to no shares and shared dispositive power as to 88,782,390 shares; that shares held by State Street on behalf of the Trust and Company-sponsored equity-based compensation program amounted to 5.65% of the common stock as of December 31, 2005; and that State Street disclaimed beneficial ownership of all shares reported therein.

(3) Based on a Schedule 13G Information Statement filed on January 26, 2006 by Barclays Global Investors, N.A., Barclays Global Fund Advisors, Barclays Global Investors, Ltd, Barclays Global Investors Japan Trust and Banking Company Limited. In the Schedule 13G, the reporting entities do not affirm the existence of a group. The Schedule 13G discloses that the reporting entities, taken as a whole, had sole voting and sole dispositive power as to 56,379,426 shares and 64,581,639 shares, respectively, and did not have shared power as to any shares.

Accordingly, there is no entity owning or controlling, either directly or indirectly, Morgan Stanley.

## Share Capital

The authorised share capital of Morgan Stanley at 31 May 2006 comprised 3,500,000,000 ordinary shares of nominal value U.S.\$0.01.

The issued, non-assessable and fully paid up share capital of Morgan Stanley at 31 May 2006 comprised 1,211,701,552 ordinary shares of nominal value U.S.\$0.01.

## **Certificate of Incorporation**

Morgan Stanley's objects and purposes are set out on page 1 of its Certificate of Incorporation and enable it to engage in any lawful act or activity for which corporations may be organised and incorporated under the DGCL.

## **Selected Financial Information**

The Selected Financial Information relevant for this Base Prospectus can be found on page 32 of Morgan Stanley's Annual Report on Form 10-K for the year ended 30 November 2005, on page 27 of Morgan Stanley's Annual Report on Form 10-K for the year ended 30 November 2004, on page 5 of Morgan Stanley's Quarterly Report on Form 10-Q for the quarterly period ended 28 February 2006, and on page 6 of Morgan Stanley's Quarterly Report on Form 10-Q for the quarterly period ended 31 May 2006. All of these documents (except for Form 10-Q for the quarterly period ended 31 May 2006) have been incorporated by reference into this Base Prospectus as set out under "Incorporation by Reference". Form 10-Q for the quarterly period ended 31 May 2006 is set out in Annex C of this Base Prospectus

## **Financial Information**

Financial information relating to Morgan Stanley is contained in the Forms 10-K of Morgan Stanley for the fiscal years ended 30 November 2005 and 30 November 2004, respectively, Form 10-Q for the quarterly period ended 28 February 2006 and Forms 8-K dated 22 February 2006 and 12 October 2005 and the proxy statement dated 24 February 2006, which are incorporated by reference into this Base Prospectus as set out in "Incorporation by Reference", and in Form 10-Q for the quarterly period ended 31 May 2006 which is set out in Annex C of this Base Prospectus (the "**Financial Information**").

There has been no material adverse change in the prospects of Morgan Stanley and its consolidated subsidiaries since 30 November 2005.

### *Auditing of Historical Financial Information*

The Auditors have audited in accordance with the standards of the Public Company Accounting Oversight Board (United States) (i) the consolidated statements of financial condition of Morgan Stanley as of 30 November 2005 and 2004 and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders' equity for each of three years in the period ended 30 November 2005; (ii) the related financial statement schedule included in Schedule I and (iii) management's report of the effectiveness of internal control over financial reporting (which reports on the financial statements and financial statement schedule each express an unqualified opinion and include an explanatory paragraph relating to the adoption in 2005 of Statement of Financial Accounting Standards No.124(R), "Share-Based Payment" and in the case of the report on the financial statements, the change in classification of repurchase transactions in the consolidated statements of cash flows) appearing in Morgan Stanley's Annual Report on Form 10-K for the year ended November 2005.

### *Legal and Arbitration Proceedings*

Except for the legal proceedings referred to under Part I. Item 3. "Legal Proceedings" in Morgan Stanley's Annual Report on Form 10-K for the year ended 30 November 2005 (pages 24-29) and under Part II. Item 1. "Legal Proceedings" in Morgan Stanley's Quarterly Report on Form 10-Q for the quarterly period ended 28 February 2006 (page 78) which are incorporated by reference into this Base Prospectus as set out under "Incorporation by Reference", and under Part II. Item 1. "Legal Proceedings" in Morgan Stanley's Quarterly Report on Form 10-Q for the quarterly period ended 31 May 2006 (pages 85-87) which is set out in Annex C of this Base Prospectus, there are no, nor have there been any, legal, governmental or arbitration proceedings (including any such proceedings which are pending or threatened of which Morgan Stanley is aware during the 12 month period before the date of this Base

Prospectus) involving Morgan Stanley or any of its consolidated subsidiaries which may have or have had in the recent past, a significant effect on Morgan Stanley's consolidated financial position or profitability.

## MORGAN STANLEY JERSEY

### History and Development

Morgan Stanley (Jersey) Limited was incorporated in St. Helier, Jersey, Channel Islands (registration number 35857) as a company with unlimited duration on 24 September 1986. It has its registered office at 22 Grenville Street, St. Helier, Jersey JE4 8PX, Channel Islands, telephone number +44 (0)1534 609000.

### Legislation

Morgan Stanley Jersey is subject to the Companies (Jersey) Law 1991, as amended.

### Investments

All material assets of Morgan Stanley Jersey are obligations of (or securities issued by) one or more Morgan Stanley group companies.

### Principal Activities

Morgan Stanley Jersey's business primarily consists of issuing financial instruments and the hedging of obligations relating thereto.

### Principal Markets

Morgan Stanley Jersey conducts its business from Jersey. All material assets of Morgan Stanley Jersey are obligations of (or securities issued by) one or more Morgan Stanley group companies. Morgan Stanley Jersey does not undertake such business on a competitive basis, however as a member of the Morgan Stanley group it is indirectly affected by some of the competitive pressures that apply to Morgan Stanley. See "Morgan Stanley" above for further details.

### Organisational Structure

Morgan Stanley Jersey has no subsidiaries. It is wholly owned by Morgan Stanley.

### Trend Information

Morgan Stanley Jersey intends to continue issuing securities and entering hedges in respect of such issues of securities.

There has been no significant change in the financial or trading position, nor any material adverse change in the prospects of, Morgan Stanley Jersey since 30 November 2005.

### Management

The directors of Morgan Stanley Jersey, their respective business addresses and principal outside activities as at the date hereof are:

*Name and Business Address*

*Principal Outside Activity*

Joel Hodes  
Morgan Stanley  
1585 Broadway  
New York, New York 10920  
U.S.A.

Managing Director, Morgan Stanley

Charles Edward Crossley Hood  
Morgan Stanley  
25 Cabot Square  
Canary Wharf  
London E14 4QA

Managing Director, Morgan Stanley

John Roberts  
Morgan Stanley  
1585 Broadway  
New York, New York 10920  
U.S.A.

Managing Director, Financing Products Group  
Morgan Stanley

John Roberts has given notice of his intention to resign as a director of Morgan Stanley Jersey.

There are no existing or potential conflicts of interest between any duties owed to Morgan Stanley Jersey by its management (as described above) and the private interests and/or other external duties owed by these individuals.

The secretary of Morgan Stanley Jersey is Mourant & Co. Secretaries Limited of 22 Grenville Street, St. Helier, Jersey JE4 8PX, Channel Islands.

#### **Board Practice**

Morgan Stanley Jersey considers itself to be in compliance with all Jersey laws relating to corporate governance that are applicable to it.

As of the date of this Base Prospectus, Morgan Stanley Jersey does not have an audit committee.

#### **Shareholders**

Morgan Stanley Jersey is wholly owned by Morgan Stanley. Morgan Stanley Jersey is not aware of any control measures with respect to such shareholder control. All decisions to issue securities are taken by the Board and Morgan Stanley Jersey earns a spread on all its issues of securities.

#### **Share Capital**

The authorised share capital of Morgan Stanley Jersey comprises 10,000 ordinary shares of nominal value GBP1.

The issued, allotted and fully paid up share capital of Morgan Stanley Jersey comprises 10,000 ordinary shares of nominal value GBP1.

#### **Memorandum and Articles of Association**

Morgan Stanley Jersey's objects and purposes are not specified in any document and are therefore unlimited.

#### **Selected Financial Information**

The (loss) / profit before tax for the financial years ended November 2005 and 2004 was nil and U.S.\$(16,000) respectively. The current assets of Morgan Stanley Jersey have fallen from U.S.\$4,758,540,000 in 2004 to U.S.\$3,598,223,000 in 2005 with total creditors falling from U.S.\$4,758,084,000 in 2004 to U.S.\$3,597,767,000 in 2005.

Morgan Stanley Jersey's Annual Report and Accounts dated 30 November 2005 are set out in Annex A of this Base Prospectus.

## MSBV

### History and Development

Morgan Stanley B.V. was incorporated as a private limited company under the laws of The Netherlands on 6 September 2001 for an unlimited duration. MSBV is registered at the commercial register of the Chamber of Commerce and Industries for Amsterdam under registered number 34161590 with registered offices at Locatellikade 1, 1076 AZ Amsterdam, The Netherlands, telephone number +31 20 57 55 600.

### Legislation

MSBV is incorporated under, and subject to, the laws of The Netherlands.

### Investments

All material assets of MSBV are obligations of (or securities issued by) one or more Morgan Stanley group companies.

### Principal Activities

MSBV's objects are, inter alia, to issue notes, warrants and other securities.

### Principal Markets

MSBV conducts its business from the Netherlands. All material assets of MSBV are obligations of (or securities issued by) one or more Morgan Stanley group companies. MSBV does not undertake such business on a competitive basis, however as a member of the Morgan Stanley group it is indirectly affected by some of the competitive pressures that apply to Morgan Stanley. See "Morgan Stanley" above for further details.

### Organisational Structure

MSBV has no subsidiaries. It is ultimately controlled by Morgan Stanley.

### Trend Information

MSBV intends to continue issuing securities and entering hedges in respect of such issues of securities.

There has been no significant change in the financial or trading position, nor any material adverse change in the prospects, of MSBV since 30 November 2005.

### Management

The current directors of MSBV, their offices, if any, within MSBV, and their principal outside activity, if any, are listed below. The business address of each director is Locatellikade 1, 1076 AZ Amsterdam, The Netherlands.

<i>Name</i>	<i>Title</i>	<i>Principal Outside Activity</i>
C.E.C. Hood	Managing Director	Managing Director, Morgan Stanley
J. Solan	Executive Director	Executive Director, Morgan Stanley
G.C. De Boer	Managing Director	Executive Director and Sales Director, Morgan Stanley Investment Management

TMF Management B.V.                      Managing Director

**Directors of TMF Management B.V.**

R.W. de Koning	Managing Director	Employee of TMF Nederland B.V.
F.A.J. van Oers	Managing Director	Employee of TMF Nederland B.V.
T.J. van Rijn	Managing Director	Employee of TMF Nederland B.V.
R.A. Rijntjes	Managing Director	Employee of TMF Nederland B.V.
M.C. van der Sluijs-Plantz	Managing Director	Employee of TMF Nederland B.V.
J.R. de Vos van Steenwijk	Managing Director	Employee of TMF Nederland B.V.
J. Versluis	Managing Director	Employee of TMF Nederland B.V.
R.A.M. van de Voort	Managing Director	Employee of TMF Nederland B.V.

There are no existing or potential conflicts of interest between any duties owed to MSBV by its management (as described above) and the private interests and/or other external duties owed by these individuals.

**Board Practice**

MSBV considers itself to be in compliance with all Netherlands laws relating to corporate governance that are applicable to it.

As of the date of this Base Prospectus, MSBV does not have an audit committee.

**Shareholders**

MSBV is ultimately controlled by Morgan Stanley. MSBV is not aware of any control measures with respect to such shareholder control. All decisions to issue securities are taken by the Board and MSBV earns a spread on all its issues of securities.

**Share Capital**

The authorised share capital of MSBV comprises 900 ordinary shares of nominal value EUR100.

The issued, allotted and fully paid up share capital of MSBV comprises 180 ordinary shares of nominal value EUR100.

**Memorandum and Articles of Association**

MSBV's objects and purposes are set out in its Articles of Association and enable it to issue, sell, purchase, transfer and accept warrants, derivatives, certificates, debt securities, equity securities and/or similar securities or instruments and to enter into hedging arrangements in connection with such securities and instruments. Furthermore its objects are to finance businesses and companies, to borrow, to lend and to raise funds as well as to enter into agreements in connection with the aforementioned, to render guarantees, to bind the company and to pledge its assets for obligations of the companies and enterprises with which it forms a group and on behalf of third parties and to trade in currencies, securities and items of property in general.

### **Selected Financial Information**

The net revenue for the financial years ended 30 November 2005 and 2004 was EUR 1,614,000 and EUR 3,638,000 respectively, representing issuance fees received on the issuance of financial instruments less guarantee fees payable. The (loss)/profit before tax for the financial years ended 30 November 2005 and 2004 was EUR(1,475,000) and EUR 3,660,000 respectively. The current assets of MSBV have risen from EUR 415,715,000 in 2004 to EUR 641,974,000 in 2005 with total creditors rising from EUR 126,158,000 to EUR 636,732,000 in 2005. The principal reason for the increase in issuances is an increase in client demand for financial instruments.

MSBV's Annual Report and Accounts dated 30 November 2005 are set out in Annex B of this Base Prospectus.

## KEY FEATURES OF THE SECURITIES

The following summary describes the key features of the Securities that each Issuer is offering under the Program in general terms only. Investors should read the summary together with the more detailed information that is contained in this Base Prospectus and in the applicable Final Terms.

<b>Issuers</b> .....	Morgan Stanley, Morgan Stanley Jersey, MSBV and any Additional Issuer
<b>Guarantor</b> .....	In the case of Securities issued by Morgan Stanley Jersey, MSBV or an Additional Issuer, unless specified otherwise in the applicable Final Terms or, in the case of an Additional Issuer, the accession agreement pursuant to which such Additional Issuer accedes to the Program, Morgan Stanley
<b>Distribution Agents</b> .....	Morgan Stanley & Co. International Limited and Morgan Stanley & Co. Incorporated
<b>Principal Securities Agent</b> .....	JPMorgan Chase Bank, N.A., London Branch
<b>Irish Securities Agent</b> .....	J.P. Morgan Bank (Ireland) plc
<b>Irish Listing Agent</b> .....	J.P. Morgan Bank (Ireland) plc
<b>Issuance in Series</b> .....	Securities will be issued in series (each, a " <b>Series</b> "). Each Series may comprise one or more tranches (" <b>Tranches</b> " and each, a " <b>Tranche</b> ") issued on different issue dates.
<b>Terms and Conditions</b> .....	<p>A Final Terms (a "<b>Final Terms</b>") will be prepared in respect of each Tranche of Securities. The terms and conditions applicable to each Tranche issued by Morgan Stanley, Morgan Stanley Jersey or MSBV will be those set out herein under the heading "Terms and Conditions of the Securities" as supplemented, modified or replaced by the applicable Final Terms. The terms and conditions applicable to each Tranche issued by an Additional Issuer will be those set out in the relevant Supplemental Base Prospectus, as supplemented, modified or replaced by the applicable Final Terms.</p> <p>Any Issuer may issue Securities that are Share Securities, Share Basket Securities, Index Securities, Index Basket Securities, Currency Securities, Commodity Securities and Bond Securities (each as defined in Condition 1 of "<i>Terms and Conditions of the Securities</i>").</p>
<b>Forms of Securities</b> .....	Each Tranche of Securities will (unless otherwise specified in the applicable Final Terms) at all times be represented by a Global Warrant (the

**Warrant**"). The Global Warrant will be deposited on the issue date therefor with a common depository for Euroclear, Clearstream, Luxembourg and/or any other relevant Clearing System. Securities in definitive bearer form will only be issued if so specified in the applicable Final Terms.

**Style of Securities** .....

Securities may be exercisable on any day during a specified exercise period ("**American Style Securities**"), on a specified expiration date ("**European Style Securities**") or on specified dates during a specified exercise period ("**Bermudan Style Securities**"), as specified in the applicable Final Terms. If so specified in the applicable Final Terms, Securities may be deemed exercised on the expiration date thereof.

**Settlement of Securities** .....

Upon exercise, Securities may entitle the Securityholder to receive from the relevant Issuer a cash settlement amount (as specified or calculated in accordance with the applicable Final Terms) ("**Cash Settlement Securities**"), or may entitle the Securityholder to receive delivery of or to deliver an amount of securities (as specified or calculated in accordance with the relevant Supplement) ("**Physical Settlement Securities**"), as specified in the applicable Final Terms.

**Minimum Exercise Number** .....

Securities are exercisable in the minimum number (or, if so specified, integral multiples thereof) specified in the applicable Final Terms.

**Status** .....

The Securities will be direct and general obligations of the relevant Issuer.

**Guarantee** .....

The payment of all amounts due in respect of Secur issued by Morgan Stanley Jersey, MSBV or Additional Issuer will, unless specified otherwise in applicable Final Terms or, in the case of an Additi Issuer, in the accession agreement pursuant to w such Additional Issuer accedes to the Program unconditionally and irrevocably guaranteed by Mo Stanley pursuant to a deed of guarantee dated as o June 2002.

**Taxation** .....

The Securityholders shall be liable for any applic taxes, duties and other charges due in relation to, *inter alia*, the issue, transfer, transmission and/or settler of the Securities. In the case of Cash Settler Securities, the relevant Issuer shall be entitlec withhold or deduct from any amounts otherwise pay to the Securityholders such amount as is necessary the payment of such taxes, duties and other charge

the case of Physical Settlement Securities, the relevant Issuer's obligation to deliver an amount of securities shall be subject to payment by the relevant Securityholders, or shall be reduced by such amount to take account, of an amount in respect of such taxes, duties and other charges.

**Listing .....**

Applications have been made for the Securities issued under the Program during the period of 12 months from the date of this Base Prospectus to be admitted to the Official List, subject to the IFSRA Rules, and to be admitted to trading on the Irish Stock Exchange. The applicable Final Terms will specify whether an issue of Securities will be admitted to the Official List and to trading on the Irish Stock Exchange or admitted to listing, trading and/or quotation by any other listing authority, stock exchange and/or quotation system as the relevant Issuer and any Distribution Agent may agree. Securities issued under the Program may also be unlisted.

**Clearance Systems .....**

Euroclear, Clearstream, Luxembourg and/or any other clearing systems as may be specified in the applicable Final Terms.

**Governing Law.....**

The Securities will be governed by, and construed in accordance with, English law.

**Selling Restrictions.....**

**The Securities may not be offered, sold or delivered at any time, directly or indirectly, within the United States or to or for the account of U.S. Persons defined in any of Regulation S under the Securities Act, the Code or the United States Commodity Exchange Act).** For a description of certain restrictions on offers, sales and deliveries of the Securities and on the distribution of offering material in the United States and in certain other countries, see "Subscription and Sale" and "No Ownership by U.S. Persons."

## PRO FORMA FINAL TERMS FOR WARRANTS AND CERTIFICATES

FINAL TERMS dated [•]

Series Number: [•]

Tranche: [•]

Common Code: [•]

ISIN: [•]

Morgan Stanley

[•]

as Issuer

[MORGAN STANLEY  
as Guarantor]

*PROGRAM FOR THE ISSUANCE OF  
WARRANTS AND CERTIFICATES*

**Issue of [Aggregate Nominal Amount of Tranche] [Title of Warrants/Certificates]**

THE [WARRANTS/CERTIFICATES] DESCRIBED HEREIN HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE UNITED STATES SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR THE SECURITIES LAWS OF ANY STATE IN THE UNITED STATES, AND ARE SUBJECT TO U.S. TAX LAW REQUIREMENTS. THE [WARRANTS/CERTIFICATES] DESCRIBED HEREIN MAY NOT BE OFFERED, SOLD OR DELIVERED AT ANY TIME, DIRECTLY OR INDIRECTLY, WITHIN THE UNITED STATES OR TO OR FOR THE ACCOUNT OF U.S. PERSONS (AS DEFINED IN EITHER REGULATIONS UNDER THE SECURITIES ACT OR THE UNITED STATES INTERNAL REVENUE CODE OF 1986, AS AMENDED). SEE "SUBSCRIPTION AND SALE" AND "NO OWNERSHIP BY U.S. PERSONS" IN THE BASE PROSPECTUS DATED 12 JULY 2006. IN PURCHASING THE [WARRANTS/CERTIFICATES], PURCHASERS WILL BE DEEMED TO REPRESENT AND WARRANT THAT THEY ARE NEITHER LOCATED IN THE UNITED STATES NOR A U.S. PERSON AND THAT THEY ARE NOT PURCHASING FOR, OR FOR THE ACCOUNT OR BENEFIT OF, ANY SUCH PERSON. THE [WARRANTS/CERTIFICATES] ARE NOT RATED.

This document constitutes Final Terms relating to the issue of [Warrants/Certificates] described herein. Terms used herein shall be deemed to be defined as such for the purposes of the Terms and Conditions of the Securities (the "**Conditions**") set forth in the Base Prospectus dated 12 July 2006 [and the supplemental Base Prospectus dated [•]]<sup>1</sup> which [together] constitute[s] a base prospectus (the "**Base Prospectus**") for the purposes of the Prospectus Directive (Directive 2003/71/EC) (the "**Prospectus Directive**"). The [Warrants/Certificates] shall constitute Securities for the purposes of the Conditions. This document constitutes the Final Terms of the [Warrants/Certificates]

<sup>1</sup> Only include details of a supplemental Prospectus in which the Conditions have been amended for the purposes of all issues under the Programme.

described herein for the purposes of Article 5.4 of the Prospectus Directive and must be read in conjunction with such Base Prospectus [as so supplemented]. Full information on the Issuer and the offer of the [Warrants/Certificates] is only available on the basis of the combination of these Final Terms and the Base Prospectus.

**Information Concerning Investment Risk**

[ ]

**General**

1. Issuer: [Morgan Stanley/Morgan Stanley (Jersey) Limited/Morgan Stanley B.V.]
2. Guarantor: [Morgan Stanley]
3. Aggregate Number of [•]  
[Warrants/Certificates] in the Series:
4. Aggregate Number of [•]  
[Warrants/Certificates] in the Tranche:
5. Issue Date: [•]
6. Issue Price: [currency][amount] per [Warrant/Certificate]
7. [Warrant/Certificate] Style: [American/European/Bermudan] Style  
(Condition 4) [Warrants/Certificates]
  - (i) [Exercise Period:] [As defined in Condition 1]
  - (ii) [Potential Exercise Dates:] [Each day from and including the Commencement Date to and including the Latest Exercise Time on the Expiration Date]
  - (iii) [Commencement Date:] [•]
8. Type: The [Warrants/Certificates] are [Index / Index Basket / Share / Share Basket / Bond / Currency / Commodity / [Warrants/Certificates]]
 

*For Share and Share Basket [Warrants/Certificates] only*

  - (i) Underlying Security: [•]
  - (ii) Relevant Issuer: [•]
  - (iii) Exchange(s): [•]
  - (iv) Related Exchange: [•][All Exchanges]
  - (v) Exchange Business Day: [•]
  - (vi) Initial Date [•]

- (vii) Additional Disruption Events Change in Law, Hedging Disruption, Loss of Stock Borrow and Increased Cost of Hedging shall apply [specify if any are not applicable, or any further Additional Disruption Events]

*For Index and Index Basket [Warrants/Certificates] only*

- (i) Index/Indices: [•]
- (ii) Exchange(s): [•][specify whether Multi-exchange Index]
- (iii) Related Exchange(s): [•][All Exchanges]
- (iv) Exchange Business Day: [•]

*For Commodity [Warrants/Certificates] only*

- (i) Commodity/Commodity Basket/Commodity Index [•][if applicable, specify whether Non Metal, Base Metal or Precious Metal]
- (ii) Commodity Reference Price [•]
- (iii) Specified Price [[high][low][average of high and low][closing price][opening price][bid] [asked] [average of high and low prices][settlement price][official settlement price][official price][morning fixing][afternoon fixing][spot price][Other (specify)]
- (iv) Delivery Date [•]
- (v) Pricing Date [•]
- (vi) Commodity Disruption Events [Price Source Disruption]  
[Trading Disruption]  
[Disappearance of Commodity Reference Price]  
[Material Change in Formula]  
[Material Change in Content]  
[Tax Disruption]  
[Trading Limitation]  
[specify any applicable additional Commodity Disruption Events][Not Applicable]
- (vii) Common Pricing [Applicable/Not Applicable] (where Commodity Basket only)

*For Currency [Warrants/Certificates] only*

- (i) Settlement Currency [•]

- (ii) Reference Currency [•]
- (iii) Specified Amount [•]
- (iv) Specified Rate [*select one from definition of Specified Rate in Condition 1*]
- (v) Settlement Rate Option [Currency Reference Dealers]
- (vi) Valuation Date [•]
- (vii) Averaging Dates [Applicable/Not Applicable]
- (viii) Other special terms and conditions [•]

*For all [Warrants/Certificates]:*

- 9. Minimum Transfer Amount: [•]  
(*Condition 2.3*)

#### **Exercise**

- 10. Expiration Date: [•]
- 11. Latest Exercise Time: [•] [(local time in the place where the Clearance System through which the relevant [Warrant/Certificate] is exercised is located)]
- 12. Minimum Exercise Number: [[•]/Not applicable]  
(*Condition 5.10*)
- 13. Permitted Multiple: [[•]/Not applicable]  
(*Condition 5.10*)
- 14. Deemed Exercise: [[•]/Not applicable]  
(*Condition 5.6*)

#### **Settlement**

- 15. Settlement Basis: The [Warrants/Certificates] are [Physical/Cash] Settlement [Warrants/Certificates].  
(*Condition 4*)  
  
*For Physical Settlement [Warrants/Certificates] only:<sup>2</sup>*
- 16. Ratio: [•] [Warrant(s)/Certificate(s)] relates to [•] [Underlying Security/Securities]
- 17. Strike Price Payment Date: [•]

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<sup>2</sup> Note that if Physical Settlement Warrants/Certificates are to be listed, the underlying must be "transferable securities" and must not be linked to any member of the Morgan Stanley group. See Article 2 (1)(m)(ii) of the Prospectus Directive

18. Strike Price: [•]  
19. Settlement Price: [[•]/Not applicable]  
20. Physical Settlement Date: [As defined in Condition 1]

*For Cash Settlement  
[Warrants/Certificates] only:*

21. Cash Settlement Amount: [•]  
22. Determination Date:  
(Condition 5.8.1) [•]  
23. Valuation Time: [•]  
24. Valuation Date: [•]  
25. Averaging Dates: [•]  
26. Settlement Currency: [•]  
27. Cash Settlement Payment Date: [•]

*For all [Warrants/Certificates]:*

**Additional details**

28. Determination Agent: [As defined in the Conditions]  
29. Listing: [•]

[The proposed European Union Transparency Obligations Directive (the "**Directive**") may be implemented in a manner which could be burdensome for companies such as the Issuer or the Guarantor. In particular, companies may be required to publish financial statements more frequently than they otherwise would or to prepare financial statements in accordance with accounting standards other than the ones they would otherwise utilise, for example the Guarantor may be required to prepare financial statements in accordance with accounting standards other than U.S. GAAP. The Issuer is under no obligation to maintain the listing of the [Warrants/Certificates], and prospective purchasers of [Warrants/Certificates] should be aware that, in circumstances where a listing of the [Warrants/Certificates] by the Irish Stock Exchange Limited would require publication by the Issuer or the Guarantor of financial statements more frequently than either would otherwise prepare them or preparation by the Guarantor of

financial statements in accordance with standards other than U.S. GAAP, or in any other circumstances where the Directive is implemented in a manner that, in the opinion of the Issuer or the Guarantor, is burdensome for the Issuer or the Guarantor, the [Warrants/Certificates] may be delisted. In such a case of de-listing, the Issuer may, but is not obliged to, seek an alternative listing for the [Warrants/Certificates] on a stock exchange outside the European Union. However, if such an alternative listing is not available or is, in the opinion of the Issuer or the Guarantor, burdensome, an alternative listing for the [Warrants/Certificates] may not be considered. Although no assurance is made as to the liquidity of the [Warrants/Certificates] as a result of listing by the Irish Stock Exchange Limited, de-listing the [Warrants/Certificates] may have a material effect on a Securityholder's ability to resell the [Warrants/Certificates] in the secondary market]

- 30. Clearance Systems: [Euroclear and Clearstream, Luxembourg]
- 31. Additional Selling Restrictions: [•]

**[LISTING AND ADMISSION TO TRADING APPLICATION**

These Final Terms comprise the final terms required to list and have admitted to trading the issue of [Warrants/Certificates] described herein pursuant to the Program for the Issuance of Warrants and Certificates of [Morgan Stanley/Morgan Stanley (Jersey) Limited/Morgan Stanley B.V.]

**RESPONSIBILITY**

The Issuer [and the Guarantor] accept[s] responsibility for the information contained in these Final Term: been extracted from •. [Each of the] [The] Issuer [and the Guarantor] confirms that such information l accurately reproduced and that, so far as it is aware, and is able to ascertain from information published by • facts have been omitted which would render the reproduced information inaccurate or misleading. ]

Signed on behalf of the Issuer:

By: .....  
Duly authorised

[Signed on behalf of the Guarantor:

By: .....  
Duly authorised]

## TERMS AND CONDITIONS OF THE SECURITIES

*The following are the terms and conditions of the Securities which (subject to completion and amendment) shall be applicable to each Series of Securities issued by Morgan Stanley, Morgan Stanley (Jersey) Limited or Morgan Stanley B.V. provided that the relevant Final Terms in relation to any Series of Securities may supplement the terms and conditions and/or may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the following terms and conditions, replace the following terms and conditions for the purposes of such Series of Securities.*

This security is one of a series (each, a "**Series**") of Warrants (the "**Warrants**") or Certificates (the "**Certificates**") and, together with the Warrants, the "**Securities**") issued by Morgan Stanley ("**Morgan Stanley**") pursuant to a securities agency agreement dated 30 November 2000 (as modified and restated on 4 December 2001 and on 30 June 2005, and as further modified and restated on 11 July 2006, the "**Securities Agreement**", which expression shall include any further amendments or supplements thereto) to which Morgan Stanley (Jersey) Limited and Morgan Stanley B.V. acceded and by which they are bound pursuant to the terms of accession agreements dated respectively as of 10 June 2002 and as of 16 April 2004. The other parties to the Securities Agreement are (1) Morgan Stanley, (2) JPMorgan Chase Bank, N.A. (formerly known as The Chase Manhattan Bank), London Branch, as principal Securities Agent (the "**Principal Securities Agent**", which expression includes any successor or substitute principal Securities Agent appointed in accordance with the Securities Agreement), and (3) J.P. Morgan Bank (Ireland) plc (formerly known as Chase Manhattan Bank (Ireland) plc), as Securities Agent (together with the Principal Securities Agent and any other Securities Agents appointed under the Securities Agreement, the "**Securities Agents**"). In the following provisions of these terms and conditions (the "**Conditions**"), each reference to the "**Issuer**" is a reference to whichever of Morgan Stanley, Morgan Stanley (Jersey) Limited and Morgan Stanley B.V. is identified as the Issuer in the relevant Final Terms (as defined below). The payment obligations of Morgan Stanley (Jersey) Limited and Morgan Stanley B.V. in respect of Securities issued by them under the Program are (unless otherwise stated in the relevant Final Terms) guaranteed by Morgan Stanley (the "**Guarantor**") under the terms of a deed of guarantee dated 10 June 2002.

In relation to a Series of Securities, the expression "**Securities**" shall, unless the context otherwise requires, include any further Warrants or, as the case may be, Certificates issued pursuant to Condition 18 (*Further Issues*) and the Conditions and forming a single series with such Series. The Securityholders (as defined below) are entitled to the benefit of, and are bound by and are deemed to have notice of, all the provisions of the Securities Agreement, the Conditions and the Final Terms (as defined below) relating to the relevant Securities.

Each Series of Securities may comprise one or more tranches ("**Tranches**" and each, a "**Tranche**") of Securities. Each Tranche will be the subject of a set of Final Terms supplemental hereto (each, "**Final Terms**"), a copy of which will, in the case of a Tranche in relation to which application has been made for admission to the Official List and to trading on the Irish Stock Exchange, be lodged with the Irish Stock Exchange, and copies of which may be obtained free of charge from the specified office of the Principal Securities Agent. In the case of a Tranche in relation to which application has not been made for admission to listing, trading and/or quotation by any listing authority, stock exchange and/or quotation system, copies of the relevant Final Terms will only be available for inspection by a Holder of Securities of that Tranche.

References in the Conditions to Securities are to the Securities of the relevant Series and references to the Issuer, the Guarantor, the Principal Securities Agent, the Determination Agent, any Holder or the Securityholders are to those persons in relation to the Securities of the relevant Series. Capitalised terms used but not defined in these Conditions will have the meanings given to them in the relevant Final Terms, the absence of any such meaning indicating that such term is not applicable to the Securities of the relevant Series.

## 1. DEFINITIONS

As used in these Conditions, the following expressions shall have the following meanings in respect of any Securities or Series of Securities:

"**Affiliate**" means any entity which is (a) an entity controlled, directly or indirectly, by the Issuer, (b) an entity that controls, directly or indirectly, the Issuer or (b) an entity directly or indirectly under common control with the Issuer;

"**Bond Securities**" means Securities relating to bonds or other debt securities;

"**Business Day**" means any day, other than a Saturday or Sunday, that is neither a legal holiday nor a day on which banking institutions are authorized or required by law or regulation to close in London;

"**Business Day Convention**", in relation to any particular date, has the meaning given in the relevant Final Terms and, if so specified in the relevant Final Terms, may have different meanings in relation to different dates and, in this context, the following expressions shall have the following meanings:

- (i) "Following Business Day Convention" means that the relevant date shall be postponed to the first following day that is a Business Day;
- (ii) "Modified Following Business Day Convention" or "Modified Business Day Convention" means that the relevant date shall be postponed to the first following day that is a Business Day, unless that day falls in the next calendar month, in which case that date will be the first preceding day that is a Business Day;
- (iii) "Nearest" means that the relevant date shall be the first preceding day that is a Business Day, if the relevant date would otherwise fall on a day other than a Sunday or a Monday, and will be the first following day that is a Business Day, if the relevant date would otherwise fall on a Sunday or a Monday;
- (iv) "Preceding" means that the relevant date will be the first preceding day that is a Business Day; and
- (v) "No Adjustment" means that the relevant date shall not be adjusted in accordance with any Business Day Convention;

"**Cash Settlement Payment Date**" means, in respect of each Exercise Date, the date specified or otherwise determined as provided in the relevant Final Terms or, if such date is not a Currency Business Day, the next succeeding Currency Business Day;

"**CEA**" means the United States Commodity Exchange Act, as amended;

"**Clearance System**" means Euroclear, Clearstream, Luxembourg and/or any other clearance system located outside the United States specified in the relevant Final Terms in which Securities of the relevant Series are for the time being held, or, in relation to an Underlying Security, in which that Underlying Security is, for the time being, held;

"**Clearance System Business Day**" means, in respect of a Clearance System, any day on which such Clearance System is (or, but for the occurrence of a Settlement Disruption Event, would have been) open for the acceptance and execution of settlement instructions;

"**Clearstream, Luxembourg**" means Clearstream Banking, société anonyme;

"**Commencement Date**" means the date specified as such in the relevant Final Terms, or, if such date is not a Scheduled Trading Day, the next following Scheduled Trading Day;

"**Commodity Securities**" means any Series of Securities that relate to a Commodity or Commodities or to a Commodity Index;

"**Currency Securities**" means Securities relating to a currency exchange rate or currency exchange rates;

"**Determination Agent**" means Morgan Stanley & Co. International Limited ("**MSIL**") or, in respect of any Series of Securities, such other determination agent as may be specified in the relevant Final Terms;

"**Disrupted Day**" has the meaning ascribed thereto in Condition 6.1.2;

"**EC Treaty**" means the Treaty establishing the European Community (signed in Rome on 25 March 1957), as amended by the Treaty on European Union (signed in Maastricht on 7 February 1992) and as amended by the Treaty of Amsterdam (signed in Amsterdam on 2 October 1997), as further amended from time to time;

"**Euro**", "**euro**", "**€**" and "**EUR**" each means the lawful currency of the member states of the European Union that adopt the single currency in accordance with the EC Treaty;

"**Euroclear**" means Euroclear Bank S.A./N.V., as operator of the Euroclear System;

"**European Economic and Monetary Union**" means economic and monetary union pursuant to the EC Treaty;

"**Exercise Date**" means, in respect of any Security, the day on which such Security is deemed to have been exercised in accordance with Condition 5.6 (*Deemed Exercise*), if applicable, or on which an Exercise Notice relating to that Security is delivered in accordance with the provisions of Condition 5.1 (*Exercise Notice*);

"**Exercise Notice**" means any notice in the form scheduled to the Securities Agreement (or such other form as may from time to time be agreed by the Issuer and the Principal Securities Agent) which is delivered by a Securityholder in accordance with Condition 5.1 (*Exercise Notice*);

"**Exercise Period**" means, unless otherwise specified in the relevant Final Terms, the period beginning on (and including) the Commencement Date and ending on (and including) the Expiration Date;

"**Expiration Date**" means:

- (i) in respect of any Share Security, Share Basket Security, Index Security or Index Basket Security, the date specified as such in the relevant Final Terms (or, if such date is not a Scheduled Trading Day, the next following Scheduled Trading Day), unless such date is a Disrupted Day due to the occurrence of an event giving rise to a Disrupted Day prior to the Latest Exercise Time on such date. If such date is a Disrupted Day due to the occurrence of such an event, then the Expiration Date shall be the first succeeding Scheduled Trading Day that is not a Disrupted Day, unless each of the eight Scheduled Trading Days immediately following the original date that, but for the occurrence of a Disrupted Day, would have been the Expiration Date is a Disrupted Day. In that case, that eighth Scheduled Trading Day shall be deemed to be the Expiration Date, notwithstanding the fact that such day is a Disrupted Day. Notwithstanding the foregoing, if a Security is exercised on a Scheduled Trading Day that would have been an Expiration Date but for the occurrence of an event giving rise to a Disrupted Day, such Scheduled Trading Day shall be deemed to be the Expiration Date for the purpose of determining whether an Exercise Date has occurred during the Exercise Period; and

- (ii) in respect of any Bond Security or Commodity Security, the date specified as such in the relevant Final Terms or, if that date is not a Business Day, a Clearance System Business Day and, if specified in the relevant Final Terms, an Exchange Business Day or a Currency Business Day, the next following day that is a Business Day, a Clearance System Business Day and, as the case may be, an Exchange Business Day or a Currency Business Day;

**"Index Basket Securities"** means Securities relating to a basket of Indices;

**"Index Securities"** means Securities relating to a single Index;

**"Initial Date"** means the date specified as such in the relevant Final Terms;

**"Latest Exercise Time"** means 10:00 a.m. (local time in the place where the Clearance System through which the relevant Security is exercised is located), unless specified otherwise in the relevant Final Terms;

**"Physical Settlement Date"** means, in relation to Underlying Securities to be delivered following exercise of a Security on an Exercise Date, and unless otherwise specified in the relevant Final Terms, the first day on which settlement of a sale of such Underlying Securities on that Exercise Date customarily would take place through the relevant Clearance System, unless a Settlement Disruption Event prevents delivery of such Underlying Securities on that day;

**"Potential Exercise Date"** means:

- (i) in respect of any Share Security, Share Basket Security, Index Security or Index Basket Security, each date specified as such in the relevant Final Terms (or, if such date is not a Scheduled Trading Day, the next following Scheduled Trading Day), unless such date is a Disrupted Day due to the occurrence of an event giving rise to a Disrupted Day prior to the Latest Exercise Time on such date. If such date is a Disrupted Day due to the occurrence of such an event, then the Potential Exercise Date shall be the first succeeding Scheduled Trading Day that is not a Disrupted Day, unless each of the eight Scheduled Trading Days immediately following the original date that, but for the occurrence of a Disrupted Day, would have been the Potential Exercise Date is a Disrupted Day. In that case, that eighth Scheduled Trading Day shall be deemed to be the Potential Exercise Date, notwithstanding the fact that such day is a Disrupted Day. Notwithstanding the foregoing, if a Security is exercised on a Scheduled Trading Day that would have been a Potential Exercise Date prior to the occurrence of an event giving rise to a Disrupted Day, such Scheduled Trading Day shall be deemed to be the Potential Exercise Date for the purpose of determining whether an Exercise Date has occurred during the Exercise Period; and
- (ii) in respect of any Bond Security or Commodity Security, the dates specified in the relevant Final Terms (or, if any such date is not a Business Day, a Clearance System Business Day and, if so specified in the relevant Final Terms, an Exchange Business Day and/or a Currency Business Day, the next following date that is a Business Day, a Clearance System Business Day and, as the case may be, an Exchange Business Day and/or a Currency Business Day);

**"Principal Financial Centre"** means, in respect of any Series of Securities and any currency, the financial centre(s) for that currency specified as such in the relevant Final Terms, or, if none is specified, the financial centre or centres determined by the Determination Agent in its sole and absolute discretion;

**"Reference Dealers"** means, in respect of any Series of Securities, the dealers specified as such in the relevant Final Terms;

**"Securities Act"** means the United States Securities Act of 1933, as amended;

"**Securityholder**" has the meaning ascribed thereto in Condition 2.2 (*Title*);

"**Settlement Currency**" means, in respect of any Series of Securities, the currency specified as such in the relevant Final Terms;

"**Settlement Cycle**" means, in respect of an Underlying Security or Index, the period of Settlement Cycle Days following a trade in such Underlying Security or the securities or other property underlying such Index, as the case may be, on the Exchange in which settlement will customarily occur according to the rules of such Exchange (or, if there are multiple Exchanges in respect of an Index, the longest such period) and for this purpose "**Settlement Cycle Day**" means a day on which the relevant Clearance System at the relevant time is (or, but for the occurrence of a Settlement Disruption Event would have been) open for the acceptance and execution of settlement instructions or, if none, a day selected by the Determination Agent;

"**Settlement Election Date**" means, in respect of any Series of Securities, the date specified in the relevant Final Terms or, if such date is not a Business Day and a Clearance System Business Day, the next following day that is a Business Day and a Clearance System Business Day;

"**Share Basket Securities**" means Securities relating to a basket of Underlying Securities that are shares;

"**Share Securities**" means Securities relating to a single Underlying Security that is a share;

"**Specified Office**" means, in respect of any Series of Securities, any office or branch of the Reference Dealer located in the city specified for such purpose in the relevant Final Terms. If a city is not so specified, the Specified Office will be deemed to be an office or branch of such Reference Dealer located in the Principal Financial Centre of the Reference Currency unless no quotations are available from the relevant office or branch of such Reference Dealer in which case, the Specified Office of the relevant Reference Dealer shall be the office or branch of such Reference Dealer located in any major financial market for the purchase and sale of the Reference Currency and the Settlement Currency outside the country where the Reference Currency is the lawful currency, as selected by the Determination Agent;

"**Specified Time**" means, in respect of any Series of Securities and the determination of the Spot Rate, the time specified as such in the relevant Final Terms;

"**Strike Price**" means, in respect of any Series of Securities, the price, level or amount specified as such or otherwise determined as provided in the relevant Final Terms;

"**Strike Price Payment Date**" has the meaning ascribed thereto in the relevant Final Terms;

"**TARGET Settlement Day**" means any day on which the Trans-European Automated Real-time Gross settlement Express Transfer (TARGET) system is open;

"**Taxes**" has the meaning ascribed thereto in Condition 4.5.1 (*Physical Settlement Securities*);

"**Underlying Securities**" means shares, bonds, other debt securities, other securities or other property specified as such in the relevant Final Terms, and "**Underlying Security**" shall be construed accordingly; and

"**Underlying Security Issuer**" means, in respect of Underlying Securities, the issuer of the relevant Underlying Securities.

## 2. **FORM, TITLE AND TRANSFER**

### 2.1 *Form:*

Each Tranche of Securities will (unless so specified in the relevant Final Terms) at all times be represented by a Global Warrant (each a "**Global Warrant**") in bearer form. The Global Warrant will be deposited on the issue date (the "**Issue Date**") specified in the relevant Final Terms with a common depositary ("**Common Depositary**") for the relevant Clearance System(s). Securities in definitive bearer form will be issued only if so specified in the relevant Final Terms.

### 2.2 *Title:*

The person for the time being appearing in the books of the relevant Clearance System as the holder of a Security shall be treated for all purposes by the Issuer, the Securities Agents, the relevant Clearance System and all other persons dealing with such person as the holder thereof (a "**Securityholder**" or a "**Holder**") and as the person entitled to exercise the rights represented thereby, notwithstanding any notice to the contrary, except that (i) Euroclear shall not be treated as the Holder of any Security held in an account with Clearstream, Luxembourg on behalf of Euroclear's accountholders and (ii) Clearstream, Luxembourg shall not be treated as the Holder of any Security held in an account with Euroclear on behalf of Clearstream, Luxembourg's accountholders.

### 2.3 *Transfer:*

All transactions in (including transfers of) Securities, in the open market or otherwise, must be effected through an account at the Clearance System(s) in which the Securities to be transferred are held. Interests in the Global Warrant will be transferable in a minimum amount of such number of Securities (the "**Minimum Transfer Amount**") as is specified in the relevant Final Terms and in accordance with the rules and procedures for the time being of the relevant Clearance System.

The Securities may not be offered, sold, delivered or otherwise transferred within the United States or to or for the account or benefit of U.S. persons (as such terms are used in Regulation S under the Securities Act, the United States Internal Revenue Code of 1986 and the CEA) and will bear a legend to such effect.

## 3. **STATUS OF SECURITIES**

### 3.1 *Status of Securities:*

The Securities of each Series constitute direct and general obligations of the Issuer which rank *pari passu* among themselves.

### 3.2 *Status of Guarantee:*

The Guarantor's obligations in respect of Securities issued by Morgan Stanley (Jersey) Limited or Morgan Stanley B.V. (other than Securities the Final Terms relating to which specifies that such Securities are not guaranteed by Morgan Stanley) constitute direct and general obligations of the Guarantor which rank *pari passu* between themselves.

### 3.3 *The Issuer is not obliged to purchase or hold Underlying Securities.*

By exercising a Security, the Holder thereof shall be deemed to have agreed to such form of settlement as the Issuer may elect in accordance with Conditions 4.6 (*Optional physical settlement*) and 4.7 (*Optional cash settlement*), if applicable.

#### 4. RIGHTS ON EXERCISE OF SECURITIES

##### 4.1 *American Style Securities:*

If the Securities are specified in the relevant Final Terms as being "**American Style Securities**", then Condition 4.1 is applicable and the Securities are exercisable not later than the Latest Exercise Time on a Business Day during the Exercise Period which is a Business Day, a Clearance System Business Day and specified in the relevant Final Terms, a Scheduled Trading Day, an Exchange Business Day and/or a Currency Business Day, subject to Condition 4.9 (*Securities void on expiry*) and to prior termination of the Securities as provided in Conditions 6.3 (*Adjustments affecting Underlying Securities*) to 11 (*Provisions relating to all Securities*) and 14 (*Force Majeure and Illegality*).

##### 4.2 *European Style Securities:*

If the Securities are specified in the relevant Final Terms as being "**European Style Securities**", then this Condition 4.2 is applicable and the Securities are exercisable only not later than the Latest Exercise Time on the Expiration Date, subject to Condition 4.9 (*Securities void on expiry*) and to prior termination of the Securities as provided in Conditions 6.3 (*Adjustments affecting Underlying Securities*) to 11 (*Provisions relating to all Securities*) and 14 (*Force Majeure and Illegality*).

##### 4.3 *Bermudan Style:*

If the Securities are specified in the relevant Final Terms as being "**Bermudan Style Securities**", then this Condition 4.3 is applicable and the Securities are exercisable only not later than the Latest Exercise Time on each Potential Exercise Date, subject to Condition 4.9 (*Securities void on expiry*) and to prior termination of the Securities as provided in Conditions 6.3 (*Adjustments affecting Underlying Securities*) to 11 (*Provisions relating to all Securities*) and 14 (*Force Majeure and Illegality*).

##### 4.4 *Cash Settlement Securities:*

If the Securities are specified in the relevant Final Terms as being "**Cash Settlement Securities**", then, subject to Condition 4.6 (*Optional physical settlement*) if applicable, upon exercise each Security entitles the Holder thereof to receive from the Issuer on the Cash Settlement Payment Date an amount (the "**Cash Settlement Amount**") calculated in accordance with the relevant Final Terms in the currency (the "**Settlement Currency**") specified in the relevant Final Terms (less any amount in respect of Taxes, as defined below). The Cash Settlement Amount will be rounded down to the nearest minimum unit of the Settlement Currency, with Securities exercised at the same time by the same Securityholder being aggregated for the purpose of determining the aggregate Cash Settlement Amount payable in respect of such Securities.

##### 4.5 *Physical Settlement Securities:*

4.5.1 If the Securities are specified in the relevant Final Terms as being "Full Physical Settlement Securities", then, subject to Condition 4.7 (*Optional cash settlement*) if applicable, upon the exercise of a Security by a Securityholder, the Issuer will deliver or procure the delivery of all the Underlying Securities in respect of such Security on the Physical Settlement Date to the account of the Clearance System specified, or as may otherwise be specified, for that purpose by such Securityholder in the relevant Exercise Notice, following payment by such Securityholder to or to the order of the Issuer on or before the Strike Price Payment Date of the Strike Price (plus an amount equal to all applicable stamp tax, stamp duty reserve tax, estate, inheritance, gift, transfer, capital gains, corporation, income, property, withholding, other taxes, duties and charges ("Taxes") due by reason of the exercise of such Security and the purchase for, and credit to or to the order of

such Securityholder of such Underlying Securities and, in the case of Bond Securities, accrued interest, if any, on the Bond Security Entitlement computed by the Determination Agent in accordance with customary trade practices employed with respect to bonds or such other debt securities), all as more fully described in Condition 5 (*Exercise*).

4.5.2 If the Securities are specified in the relevant Final Terms as being "Part Physical Settlement Securities", then, subject to Condition 4.7 (*Optional cash settlement*) if applicable, upon the exercise of a Security by a Securityholder, the Issuer will deliver or procure the delivery of all the Underlying Securities in respect of such Security on the Physical Settlement Date to the account of the Clearance System specified, or as may otherwise be specified, for that purpose by such Securityholder in the relevant Exercise Notice. The number of Underlying Securities to be so delivered shall be an amount of Underlying Securities, rounded down if not a whole number, whose market value (as determined by the Determination Agent in its sole and absolute discretion) on the Exercise Date (less any commissions which the Issuer may charge at such rate as it deems fit in its sole and absolute discretion and any applicable Taxes due by reason of the exercise of such Security and the purchase for, and credit to or to the order of such Securityholder of such Underlying Securities) is equal to the excess, if any, of the Settlement Price over the Strike Price (plus, in the case of Bond Securities, any accrued interest, as specified in Condition 4.5.1 above). Where a Securityholder becomes entitled to receive Underlying Securities in respect of more than one Security, any rounding adjustment referred to in this Condition 4.5.2 shall be applied only to the aggregate number of Underlying Securities deliverable in respect of such Securities.

4.5.3 If the Securities are specified in the relevant Final Terms as being "Other Physical Settlement Securities", then, subject to Condition 4.7 (*Optional cash settlement*) if applicable, upon the exercise of a Security by a Securityholder, the Issuer will deliver or procure the delivery of such amount of Underlying Securities, or the Securities will be settled in any other manner, as may be specified in, or determined in accordance with, the relevant Final Terms.

4.5.4 In these Conditions, references to "Physical Settlement Securities" shall, where the context so admits, comprise Full Physical Settlement Securities, Part Physical Settlement Securities and Other Physical Settlement Securities.

4.6 *Optional physical settlement:*

If this Condition 4.6 is specified in the relevant Final Terms as being applicable, then, upon the exercise of a Security by a Securityholder, the Issuer may elect not to pay the Cash Settlement Amount to that Securityholder in accordance with Condition 4.4 (*Cash Settlement Securities*), but instead deliver or procure the delivery of Underlying Securities in accordance with Condition 4.5.1 (*Full Physical Settlement Securities*) or Condition 4.5.2 (*Part Physical Settlement Securities*).

4.7 *Optional cash settlement:*

If this Condition 4.7 is specified in the relevant Final Terms as being applicable, then, upon the exercise of a Security by a Securityholder, the Issuer may elect not to deliver or procure the delivery of Underlying Securities in accordance with Condition 4.5.1 (*Full Physical Settlement Securities*) or Condition 4.5.2 (*Part Physical Settlement Securities*), but instead to pay the Cash Settlement Amount to that Securityholder in accordance with Condition 4.4 (*Cash Settlement Securities*).

4.8 *Notification of election:*

If Condition 4.6 (*Optional physical settlement*) or Condition 4.7 (*Optional cash settlement*) is specified in the relevant Final Terms as being applicable, the Issuer will, by the close of business (London time) on the

Settlement Election Date, notify the relevant Clearance System(s), the Principal Securities Agent, the Determination Agent and the relevant Securityholder whether it has elected to pay the Cash Settlement Amount in accordance with Condition 4.4 (*Cash Settlement Securities*) or deliver or procure the delivery of Underlying Securities in accordance with Condition 4.5.1 (*Full Physical Settlement Securities*) or Condition 4.5.2 (*Part Physical Settlement Securities*). Notice to the relevant Securityholder shall be given by facsimile or telex to the number specified in the relevant Exercise Notice, and any notice so given shall be deemed received by the relevant Securityholder.

4.9 *Securities void on expiry:*

Subject to Condition 5.6 (*Deemed Exercise*), Securities with respect to which an Exercise Notice has not been duly completed and delivered to the relevant Clearance System and to the Principal Securities Agent, in the manner set out in Condition 5 (*Exercise*), before the Latest Exercise Time shall become void for all purposes and shall cease to be transferable.

4.10 *Delivery outside the United States:*

Notwithstanding the foregoing, no cash, securities or other property shall be delivered in the United States (as defined in Regulation S under the Securities Act and in the CEA) in connection with the settlement of, or exercise of, Securities.

5. **EXERCISE**

5.1 *Exercise Notice:*

5.1.1 Subject to Condition 4.9 (*Securities void on expiry*) and to prior termination of the Securities provided in Conditions 6.3 (*Adjustments affecting Underlying Securities*) to 11 (*Provisions relating to all Securities*) and 14 (*Force Majeure and Illegality*), Securities may be exercised by a Securityholder (at his own expense) at such time and on such day(s) as provided in Condition 4.1 (*American Style Securities*), 4.2 (*European Style Securities*) or 4.3 (*Bermudan Style Securities*), as applicable, by delivery from a location outside the United States, or by the sending of a tested telex confirmed in writing from a location outside the United States, of a duly completed and signed Exercise Notice to (i) the relevant Clearance System, (ii) the Securities Agents and (iii) the Determination Agent.

5.1.2 Subject to Condition 4.9 (*Securities void on expiry*), any Exercise Notice delivered after the Latest Exercise Time on any day shall: (a) in the case of Bermudan Style Securities and European Style Securities, be void and (b) in the case of American Style Securities, be deemed to have been delivered on the next following day on which such Securities are exercisable (unless no such day occurs on or prior to the Expiration Date, in which case that Exercise Notice shall be void).

5.2 *Form of Exercise Notice for Cash Settlement Securities:*

Each Exercise Notice shall be in the form (for the time being current) available from each Securities Agent, and must:

- (a) specify the name, address, telephone, facsimile and telex details of the Securityholder in respect of the Securities being exercised;
- (b) specify the number of Securities of the relevant Series being exercised by the Securityholder (which must not be less than the Minimum Exercise Number);

- (c) specify the number of the Securityholder's account at the relevant Clearance System to be debited with the Securities being exercised and irrevocably instruct, or, as the case may be, confirm that the Securityholder has irrevocably instructed, the relevant Clearance System to debit the Securityholder's account with the Securities being exercised and credit the same to the account of the Principal Securities Agent;
- (d) where applicable, specify the number of the Securityholder's account at the relevant Clearance System to be credited with the Cash Settlement Amount for the Securities being exercised;
- (e) include an irrevocable undertaking to pay any applicable Taxes due by reason of exercise of the relevant Securities and an authority to the Issuer and the relevant Clearance System to deduct an amount in respect thereof from any Cash Settlement Amount due to such Securityholder or otherwise (on, or at any time after, the Cash Settlement Payment Date) and to debit a specified account of the Securityholder at the relevant Clearance System with an amount or amounts in respect thereof; and
- (f) give a certification as to the non-U.S. beneficial ownership of the Securities being exercised therewith.

### 5.3 *Form of Exercise Notice for Physical Settlement Securities:*

If the Securities are specified in the relevant Final Terms as being Physical Settlement Securities or if Condition 4.6 (*Optional physical settlement*) is specified in the relevant Final Terms as being applicable, the Exercise Notice shall also:

- (a) in the case of Full Physical Settlement Securities, irrevocably instruct the relevant Clearance System to debit on the Strike Price Payment Date a specified account of the Securityholder with the aggregate Strike Price in respect of the Securities being exercised (plus any applicable Taxes and, in the case of Bond Securities, any accrued interest, as specified in Condition 4.5.1 above), and to transfer such amount to such account as shall have been specified by the Issuer to the relevant Clearance System for that purpose;
- (b) include an irrevocable undertaking to pay any applicable Taxes due by reason of the transfer (if any) of Underlying Securities to the account at the relevant Clearance System specified, or as otherwise specified, by the Securityholder and an authority to the Issuer and the relevant Clearance System to debit a specified account of the Securityholder with an amount in respect thereof;
- (c) specify the number of the Securityholder's account with the relevant Clearance System to be credited with the relevant Underlying Securities or, as the case may be, the delivery details for such Underlying Securities; and
- (d) specify such other details as the relevant Final Terms may require.

### 5.4 *Verification of Securityholder:*

5.4.1 To exercise Securities, the Holder thereof must duly complete an Exercise Notice. The relevant Clearance System shall, in accordance with its normal operating procedures, verify that each person exercising Securities is the Holder thereof according to the records of such Clearance System and that such Holder has an account at the relevant Clearance System which contains Securities in an amount being exercised and funds equal to any applicable Taxes and the aggregate Strike Price (if any) in respect of the Securities being exercised.

5.4.2 If, in the determination of the relevant Clearance System or the Principal Securities Agent:

- (a) the Exercise Notice is not complete or not in proper form;
- (b) the person submitting an Exercise Notice is not validly entitled to exercise the relevant Securities or not validly entitled to deliver such Exercise Notice; or
- (c) sufficient Securities or sufficient funds equal to any applicable Taxes and the aggregate Strike Price (if any) are not available in the specified account(s) with the relevant Clearance System on the Exercise Date,

that Exercise Notice will be treated as void and a new duly completed Exercise Notice must be submitted if exercise of the Holder's Securities is still desired.

5.4.3 Any determination by the relevant Clearance System or the Principal Securities Agent as to any of the matters set out in Condition 5.4.2 above shall, in the absence of manifest error, be conclusive and binding upon the Issuer, the Securityholder and the beneficial owner of the Securities exercised.

5.5 *Notification to Principal Securities Agent and Common Depositary:*

5.5.1 Subject to the verification set out in Condition 5.4.1 above, the relevant Clearance System will:

- (a) confirm to the Principal Securities Agent (copied to the Issuer and the Determination Agent) the number of Securities being exercised and the number of the account to be credited with the Cash Settlement Amount or, as the case may be, with the Underlying Securities; and
- (b) promptly notify the Common Depositary of receipt of the Exercise Notice and the number of the Securities to be exercised.

5.5.2 Upon exercise of part of the Global Warrant, the Common Depositary will note such exercise on the Schedule to the Global Warrant and the number of Securities so exercised as represented by the Global Warrant shall be cancelled *pro tanto*.

5.6 *Deemed Exercise:*

If "**Deemed Exercise**" is specified in the relevant Final Terms to be applicable in relation to a Series of Securities, where an Exercise Notice has not been duly completed and delivered by the Latest Exercise Time on the Expiration Date in respect of any Securities of such Series, each such Security shall be deemed to have been exercised at that time on such date and/or upon such other terms as may be specified in the relevant Final Terms, subject in each case to prior termination as provided for in 6.3 (*Adjustments affecting Underlying Securities*) to 11 (*Provisions relating to all Securities*) and 14 (*Force Majeure and Illegality*). Notwithstanding such deemed exercise, the Issuer shall be under no obligation to settle any such Security until the Holder has delivered an Exercise Notice in the prescribed form in accordance with Conditions 5.2 (*Form of Exercise Notice*) and/or 5.3 (*Form of Exercise Notice for Physical Settlement Securities*) above, provided that where the Holder has not delivered an Exercise Notice within 30 Business Days and Clearance System Business Days of the day on which such Securities were deemed to have been exercised, such Securities shall become void for all purposes.

5.7 *Debit of Securityholder's Account:*

5.7.1 The relevant Clearance System will on or before the Cash Settlement Payment Date or the Physical Settlement Date, as the case may be, debit the relevant account of the Securityholder and credit the relevant account of the Principal Securities Agent (in favour of the Issuer) with: (i) the Securities being exercised, (ii) the aggregate Strike Price (if any) in respect of the Securities being

exercised (plus any applicable Taxes and, in the case of Bond Securities, any accrued interest, as specified in Condition 4.5.1 above), and (iii) any other amounts and/or amounts of Underlying Securities as may be specified in the relevant Final Terms.

5.7.2 If any of the items set out in Condition 5.7.1 are not so credited to the relevant account of the Principal Securities Agent (in favour of the Issuer), then the Issuer shall be under no obligation to transfer any Underlying Securities or make any delivery or make any payment of any nature to the relevant Securityholder in respect of the Securities being exercised, and the Exercise Notice delivered in respect of such Securities shall thereafter be void for all purposes.

#### 5.8 *Payment and delivery:*

5.8.1 In respect of Securities which have been exercised and which are specified in the relevant Final Terms as being Cash Settlement Securities, or in respect of which the Issuer has elected cash settlement in accordance with Condition 4.7 (*Optional cash settlement*):

(a) the Determination Agent shall, on the date specified therefor (the "Determination Date") in the relevant Final Terms, determine, in its sole and absolute discretion, the Cash Settlement Amount (if any) to be paid on the relevant Cash Settlement Payment Date in respect of the relevant Securities and notify the Issuer and the Principal Securities Agent of such Cash Settlement Amount on the Business Day immediately following the Determination Date, provided that the Determination Agent has received confirmation from the relevant Clearance System of the number of Securities which have been exercised; and

(b) the Issuer will transfer to the Principal Securities Agent the Cash Settlement Amount in respect of the Securities being exercised, less any amount in respect of Taxes which the Issuer is authorised to deduct therefrom, for value on the Cash Settlement Payment Date, and the Principal Securities Agent will cause the Securityholder's account with the relevant Clearance System to be credited with such amount for value on the Cash Settlement Payment Date.

5.8.2 In respect of Securities which have been exercised and which are specified in the relevant Final Terms as being Physical Settlement Securities, or in respect of which the Issuer has elected physical settlement in accordance with Condition 4.6 (*Optional physical settlement*), subject, in the case of Full Physical Settlement Securities, to transfer of the Strike Price (plus any applicable Taxes and, in the case of Bond Securities, any accrued interest, as specified in Condition 4.5.1 above) from the relevant account of the Securityholder to the relevant account of the Principal Securities Agent (in favour of the Issuer) as aforesaid, the Issuer shall, on the Physical Settlement Date, deliver or procure the delivery of the relevant number of Underlying Securities in respect of each Security for credit to the account specified, or as may otherwise be specified, in the relevant Exercise Notice. The Issuer shall be entitled, if it so elects, to divide any Underlying Securities to be transferred into such number of lots of such size as it desires to facilitate its delivery obligations.

5.8.3 Exercise of the Securities and payments and deliveries by the Issuer and the Securities Agents will be subject in all cases to all applicable fiscal and other laws, regulations and practices in force at the relevant time (including, without limitation, any relevant exchange control laws or regulations and the rules and procedures of the relevant Clearance System) and none of the Issuer or any Securities Agent shall incur any liability whatsoever if it is unable to effect the transactions contemplated, after using all reasonable efforts, as a result of any such laws, regulations and practices. None of the Issuer or any Securities Agent shall under any circumstances be liable for

any acts or defaults of any Clearance System in the performance of the Clearance System's duties in relation to the Securities.

5.9 *Effect of Exercise Notice:*

5.9.1 Delivery of an Exercise Notice shall constitute an irrevocable election and undertaking by the Securityholder to exercise the Securities specified therein, provided that the person exercising and delivering such Exercise Notice is the person then appearing in the records of the relevant Clearance System as the holder of the relevant Securities. If the person exercising and delivering the Exercise Notice is not the person so appearing, such Exercise Notice shall for all purposes become void and shall be deemed not to have been so delivered.

5.9.2 After the delivery of an Exercise Notice (other than an Exercise Notice which shall become void pursuant to Condition 5.1.2) by a Securityholder, such Securityholder shall not be permitted to transfer either legal or beneficial ownership of the Securities exercised thereby. Notwithstanding this, if any Securityholder does so transfer or attempt to transfer such Securities, the Securityholder will be liable to the Issuer for any losses, costs and expenses suffered or incurred by the Issuer including those suffered or incurred as a consequence of it having terminated any related hedging operations in reliance on the relevant Exercise Notice and subsequently: (i) entering into replacement hedging operations in respect of such Securities; or (ii) paying any amount on the subsequent exercise of such Securities without having entered into any replacement hedging operations.

5.10 *Minimum Number of Securities Exercisable:*

The Securities are exercisable in the minimum number (the "**Minimum Exercise Number**") specified in the relevant Final Terms (or, if a "**Permitted Multiple**" is specified in the relevant Final Terms, higher integral multiples of the Minimum Exercise Number) on any particular occasion or such lesser Minimum Exercise Number or other Permitted Multiple as the Issuer may from time to time notify to the Securityholders in accordance with Condition 15 (*Notices*).

6. **PROVISIONS RELATING TO SHARE SECURITIES, SHARE BASKET SECURITIES, INDEX SECURITIES AND INDEX BASKET SECURITIES**

This Condition 6 is applicable only in relation to Securities specified in the relevant Final Terms as Share Securities, Share Basket Securities, Index Securities or Index Basket Securities.

6.1 *Valuation, Market Disruption and Averaging Dates:*

6.1.1 "**Valuation Date**" means, unless otherwise specified in the relevant Final Terms, each Exercise Date (or, if such date is not a Scheduled Trading Day, the next following Scheduled Trading Day), subject to the provisions of Condition 6.1.2. If any Valuation Date is a Disrupted Day, then:

(a) in the case of an Index Security or Share Security, the Valuation Date shall be the first succeeding Scheduled Trading Day that is not a Disrupted Day, unless each of the eight Scheduled Trading Days immediately following the Scheduled Valuation Date is a Disrupted Day. In that case, (1) that eighth Scheduled Trading Day shall be deemed to be the Valuation Date, notwithstanding the fact that such day is a Disrupted Day, and (2) the Determination Agent shall determine in its sole and absolute discretion:

(i) in respect of an Index Security, the level of the Index as of the Valuation Time on that eighth Scheduled Trading Day in accordance with the formula for and method of

calculating the Index last in effect prior to the occurrence of the first Disrupted Day using the Exchange traded or quoted price as of the Valuation Time on that eighth Scheduled Trading Day of each security or other property comprised in the Index (or, if an event giving rise to a Disrupted Day has occurred in respect of the relevant security or other property on that eighth Scheduled Trading Day, its good faith estimate of the value for the relevant security or other property as of the Valuation Time on that eighth Scheduled Trading Day); and

- (ii) in respect of a Share Security, its good faith estimate of the value for the Underlying Security as of the Valuation Time on that eighth Scheduled Trading Day;
- (b) in the case of an Index Basket Security, the Valuation Date for each Index not affected by the occurrence of a Disrupted Day shall be the Scheduled Valuation Date, and the Valuation Date for each Index affected by the occurrence of a Disrupted Day shall be the first succeeding Scheduled Trading Day that is not a Disrupted Day relating to that Index, unless each of the eight Scheduled Trading Days immediately following the Scheduled Valuation Date is a Disrupted Day relating to that Index. In that case, (1) that eighth Scheduled Trading Day shall be deemed to be the Valuation Date for the relevant Index, notwithstanding the fact that such day is a Disrupted Day, and (2) the Determination Agent shall determine, in its sole and absolute discretion, the level of that Index as of the Valuation Time on that eighth Scheduled Trading Day in accordance with the formula for and method of calculating that Index last in effect prior to the occurrence of the first Disrupted Day using the Exchange traded or quoted price as of the Valuation Time on that eighth Scheduled Trading Day of each security comprised in that Index (or, if an event giving rise to a Disrupted Day has occurred in respect of the relevant security on that eighth Scheduled Trading Day, its good faith estimate of the value for the relevant security as of the Valuation Time on that eighth Scheduled Trading Day); and
- (c) in the case of a Share Basket Security, the Valuation Date for each Underlying Security not affected by the occurrence of a Disrupted Day shall be the Scheduled Valuation Date, and the Valuation Date for each Underlying Security affected by the occurrence of a Disrupted Day shall be the first succeeding Scheduled Trading Day that is not a Disrupted Day relating to that Underlying Security, unless each of the eight Scheduled Trading Days immediately following the Scheduled Valuation Date is a Disrupted Day relating to that Underlying Security. In that case, (1) that eighth Scheduled Trading Day shall be deemed to be the Valuation Date for the relevant Underlying Security, notwithstanding the fact that such day is a Disrupted Day, and (2) the Determination Agent shall determine, in its sole and absolute discretion, its good faith estimate of the value for that Underlying Security as of the Valuation Time on that eighth Scheduled Trading Day.

6.1.2 For the purposes hereof:

**"Disrupted Day"** means (a) except with respect to a Multi-exchange Index, any Scheduled Trading Day on which a relevant Exchange or any Related Exchange fails to open for trading during its regular trading session or on which a Market Disruption Event has occurred, and (b) with respect to any Multi-exchange Index, any Scheduled Trading Day on which (i) the Index Sponsor fails to publish the level of the Index; (ii) the Related Exchange fails to open for trading during its regular trading session; or (iii) a Market Disruption Event has occurred;

**"Early Closure"** means (a) except with respect to a Multi-exchange Index, the closure on any Exchange Business Day of the relevant Exchange (or, in the case of an Index Security or Index

Basket Security, any relevant Exchange(s) relating to securities or other property that comprise(s) 20 percent or more of the level of the relevant Index) or any Related Exchange(s) prior to its Scheduled Closing Time unless such earlier closing time is announced by such Exchange(s) or Related Exchange(s) at least one hour prior to the earlier of (i) the actual closing time for the regular trading session on such Exchange(s) or Related Exchange(s) on such Exchange Business Day and (ii) the submission deadline for orders to be entered into the Exchange or Related Exchange system for execution at the Valuation Time on such Exchange Business Day and (b) with respect to any Multi-exchange Index, the closure on any Exchange Business Day of the Exchange in respect of any Component or the Related Exchange prior to its Scheduled Closing Time unless such earlier closing is announced by such Exchange or Related Exchange (as the case may be) at least one hour prior to the earlier of: (i) the actual closing time for the regular trading session on such Exchange or Related Exchange (as the case may be) on such Exchange Business Day; and (ii) the submission deadline for orders to be entered into such Exchange or Related Exchange system for execution at the relevant Determination Time on such Exchange Business Day;

**"Exchange Disruption"** means (a) except with respect to a Multi-exchange Index, any event (other than an Early Closure) that disrupts or impairs (as determined by the Determination Agent in its sole and absolute discretion) the ability of market participants in general (i) to effect transactions in, or obtain market values for, the Underlying Securities on the Exchange (or, in the case of an Index Security or Index Basket Security, on any relevant Exchange(s) in securities or other property that comprise(s) 20 percent or more of the level of the relevant Index), or (ii) to effect transactions in, or obtain market values for, futures or options contracts relating to the Underlying Security or the relevant Index on any relevant Related Exchange and (b) with respect to any Multi-exchange Index, any event (other than an Early Closure) that disrupts or impairs (as determined by the Determination Agent) the ability of market participants in general to effect transactions in, or obtain market values for, (i) any Component on the Exchange in respect of such Component; or (ii) futures or options contracts relating to the Index on the Related Exchange;

**"Market Disruption Event"** means (a) in respect of an Underlying Security or Index other than a Multi-exchange Index, the occurrence or existence of (i) a Trading Disruption, (ii) an Exchange Disruption, which in either case the Determination Agent determines is material (such determination to be at the Determination Agent's sole and absolute discretion), at any time during the one hour period that ends at the relevant Valuation Time, or (iii) an Early Closure. For the purposes of determining whether a Market Disruption Event in respect of an Index exists at any time, if a Market Disruption Event occurs in respect of a security or other property included in the Index at any time, then the relevant percentage contribution of that security or other property to the level of the Index shall be based on a comparison of (x) the portion of the level of the Index attributable to that security or other property and (y) the overall level of the Index, in each case immediately before the occurrence of such Market Disruption Event; and (b) with respect to any Multi-exchange Index either (i)(A) the occurrence or existence, in respect of any Component, of (1) a Trading Disruption, (2) an Exchange Disruption, which in either case the Determination Agent determines is material, at any time during the one hour period that ends at the relevant Valuation Time in respect of the Exchange on which such Component is principally traded, OR (3) an Early Closure; AND (B) the aggregate of all Components in respect of which a Trading Disruption, an Exchange Disruption or an Early Closure occurs or exists comprises 20 per cent. or more of the level of the Index; OR (ii) the occurrence or existence, in respect of futures or options contracts relating to the Index, of: (A) a Trading Disruption, (B) an Exchange Disruption, which in either case the Determination Agent determines is material, at any time during the one hour period

that ends at the relevant Valuation Time in respect of the Related Exchange; or (c) an Early Closure;

For the purposes of determining whether a Market Disruption Event exists in respect of a Component at any time, if a Market Disruption Event occurs in respect of such Component at that time, then the relevant percentage contribution of that Component to the level of the Index shall be based on a comparison of (x) the portion of the level of the Index attributable to that Component to (y) the overall level of the Index, in each case using the official opening weightings as published by the Index Sponsor as part of the market "opening data";

**"Scheduled Valuation Date"** means any original date that, but for the occurrence of an event causing a Disrupted Day, would have been a Valuation Date (ignoring for the purposes of this definition any postponement of the Potential Exercise Date or Expiration Date as a result of the occurrence of a Disrupted Day and assuming that the original Potential Exercise Date or original Expiration Date, as the case may be, would have been a Valuation Date); and

**"Trading Disruption"** means (a) except with respect to a Multi-exchange Index any suspension of or limitation imposed on trading by the relevant Exchange or Related Exchange or otherwise and whether by reason of movements in price exceeding limits permitted by the relevant Exchange or Related Exchange or otherwise (i) relating to the Underlying Security on the Exchange (or, in the case of an Index Security or Index Basket Security, on any relevant Exchange(s) relating to securities or other property that comprise(s) 20 percent or more of the level of the relevant Index), or (ii) in futures or options contracts relating to the Share or the relevant Index on any relevant Related Exchange and (b) with respect to any Multi-exchange Index, any suspension of or limitation imposed on trading by the Exchange or Related Exchange or otherwise and whether by reason of movements in price exceeding limits permitted by the Exchange or Related Exchange or otherwise (i) relating to any Component on the Exchange in respect of such Component; or (ii) in futures or options contracts relating to the Index on the Related Exchange.

6.1.3 If Averaging Dates are specified in the relevant Final Terms as being applicable, then, notwithstanding any other provisions of these Conditions, the following provisions will apply to the valuation of the relevant Index, Underlying Security or Basket in relation to a Valuation Date:

- (a) **"Averaging Date"** means, in respect of each Valuation Date, each date specified or otherwise determined as provided in the relevant Final Terms (or, if such date is not a Scheduled Trading Day, the next following Scheduled Trading Day).
- (b) For purposes of determining the Settlement Price in relation to a Valuation Date, the Settlement Price will be:
  - (i) in respect of an Index Security or a Share Security that is a Cash Settlement Security or a Part Physical Settlement Security, the arithmetic mean of the Relevant Prices of the Index or the Underlying Securities on each Averaging Date;
  - (ii) in respect of an Index Basket Security, the arithmetic mean of the amounts for the Basket determined by the Determination Agent in its sole and absolute discretion as provided in the relevant Final Terms as of the relevant Valuation Time(s) on each Averaging Date or, if no means for determining the Settlement Price are so provided, the arithmetic mean of the amounts for the Basket calculated on each Averaging Date as the sum of the Relevant Prices of each Index comprised in the Basket (weighted or adjusted in relation to each Index as provided in the relevant Final Terms); and

- (iii) in respect of a Share Basket Security that is a Cash Settlement Security or a Part Physical Settlement Security, the arithmetic mean of the amounts for the Basket determined by the Determination Agent in its sole and absolute discretion as provided in the relevant Final Terms as of the relevant Valuation Time(s) on each Averaging Date or, if no means for determining the Settlement Price is so provided, the arithmetic mean of the amounts for the Basket calculated on each Averaging Date as the sum of the values calculated for the Underlying Securities of each Underlying Security Issuer as the product of (1) the Relevant Price of such Underlying Security and (2) the number of such Underlying Securities comprised in the Basket.
- (c) If an Averaging Date is a Disrupted Day, then if, in relation to "**Averaging Date Disruption**", the consequence specified in the relevant Final Terms is:
  - (i) "**Omission**", then such Averaging Date will be deemed not to be a relevant Averaging Date for the purposes of determining the relevant Settlement Price Provided that, if through the operation of this provision no Averaging Date would occur with respect to the relevant Valuation Date, then Condition 6.1.1 will apply for purposes of determining the relevant level, price or amount on the final Averaging Date in respect of that Valuation Date as if such Averaging Date were a Valuation Date that was a Disrupted Day;
  - (ii) "**Postponement**", then Condition 6.1.1 will apply for the purposes of determining the relevant level, price or amount on that Averaging Date as if such Averaging Date were a Valuation Date that was a Disrupted Day irrespective of whether, pursuant to such determination, that deferred Averaging Date would fall on a day that already is or is deemed to be an Averaging Date for the relevant Security; or
  - (iii) "**Modified Postponement**", then:
    - (1) in the case of an Index Security or a Share Security, the Averaging Date shall be the first succeeding Valid Date. If the first succeeding Valid Date has not occurred as of the Valuation Time on the eighth Scheduled Trading Day immediately following the original date that, but for the occurrence of another Averaging Date or Disrupted Day, would have been the final Averaging Date in relation to the relevant Scheduled Valuation Date, then (A) that eighth Scheduled Trading Day shall be deemed to be the Averaging Date (irrespective of whether that eighth Scheduled Trading Day is already an Averaging Date), and (B) the Determination Agent shall determine, in its sole and absolute discretion, the relevant level or price for that Averaging Date in accordance with (x) in the case of an Index Security, Condition 6.1.1(a)(2)(i) and (y) in the case of a Share Security, Condition 6.1.1(a)(2)(ii);
    - (2) in the case of an Index Basket Security or a Share Basket Security, the Averaging Date for each Underlying Security or Index not affected by the occurrence of a Disrupted Day shall be the date specified in the relevant Final Terms as an Averaging Date in relation to the relevant Valuation Date and the Averaging Date for an Underlying Security or Index affected by the occurrence of a Disrupted Day shall be the first succeeding Valid Date in relation to such Underlying Security or Index. If the first succeeding Valid Date in relation to such Underlying Security or Index has not occurred as of

the Valuation Time on the eighth Scheduled Trading Day immediately following the original date that, but for the occurrence of another Averaging Date or Disrupted Day, would have been the final Averaging Date in relation to the relevant Scheduled Valuation Date, then (A) that eighth Scheduled Trading Day shall be deemed to be the Averaging Date (irrespective of whether that eighth Scheduled Trading Day is already an Averaging Date) in relation to such Underlying Security or Index, and (B) the Determination Agent shall determine, in its sole and absolute discretion, the relevant level or amount for that Averaging Date in accordance with (x) in the case of an Index Basket Security, Condition 6.1.1(b)(2) and (y) in the case of a Share Basket Security, Condition 6.1.1(c)(2); and

(3) "**Valid Date**" shall mean a Scheduled Trading Day that is not a Disrupted Day and which another Averaging Date in respect of the relevant Valuation Date does not or is not deemed to occur.

(d) If any Averaging Dates in relation to a Valuation Date occur after that Valuation Date as a result of the occurrence of a Disrupted Day, then (i) the relevant Cash Settlement Payment Date or, as the case may be, the relevant Physical Settlement Date or (ii) the occurrence of an Extraordinary Event or a Potential Adjustment Event shall be determined by reference to the last such Averaging Date as though it were that Valuation Date.

## 6.2 *Adjustments to Indices:*

This Condition 6.2 is applicable only in relation to Securities specified in the relevant Final Terms as being Index Securities or Index Basket Securities.

### 6.2.1 *Successor Index:*

If a relevant Index is (a) not calculated and announced by the Index Sponsor, but is calculated and announced by a successor sponsor acceptable to the Determination Agent in its sole and absolute discretion or (b) replaced by a successor index using, in the determination of the Determination Agent (such determination to be at the Determination Agent's sole and absolute discretion), the same or a substantially similar formula for and method of calculation as used in the calculation of that Index, then in each case that index (the "**Successor Index**") will be deemed to be the Index.

### 6.2.2 *Index Adjustment Events:*

If (i) on or prior to any Valuation Date, or any Averaging Date, a relevant Index Sponsor announces that it will make a material change in the formula for or the method of calculating that Index or in any other way materially modifies that Index (other than a modification prescribed in that formula or method to maintain that Index in the event of changes in constituent securities (or other property) and capitalisation and other routine events) (an "**Index Modification**") or permanently cancels the Index and no Successor Index exists (an "**Index Cancellation**") or (ii) on any Valuation Date, or any Averaging Date, the Index Sponsor fails to calculate and announce a relevant Index (an "**Index Disruption**" and together with an Index Modification and an Index Cancellation, each an "**Index Adjustment Event**"), then (A) in the case of an Index Modification or an Index Disruption, the Determination Agent shall determine if such Index Adjustment Event has a material effect on the Securities and, if so, shall calculate in its sole and absolute discretion the relevant Settlement Price or Final Price, as the case may be, using, *in lieu* of a published level for that Index, the level for that Index as at that Valuation Date or, as the case may be, that Averaging Date as determined by the Determination Agent in its sole and absolute discretion in

accordance with the formula for and method of calculating that Index last in effect prior to that change, failure or cancellation, but using only those securities or other property that comprised that Index immediately prior to that Index Adjustment Event and (B) in the case of an Index Cancellation, the Issuer may, at any time thereafter and in its sole and absolute discretion, determine that the Securities shall be terminated as of any later date. If the Issuer so determines that the Securities shall be terminated, then the Securities shall cease to be exercisable (or, in the case of any Securities which have been exercised, the entitlements of the respective exercising Securityholders to receive the Underlying Securities or payment of the Cash Settlement Amount, as the case may be, pursuant to such exercise shall cease) as of such later date and the Issuer will pay an amount which the Determination Agent, in its sole and absolute discretion, determines is the fair value to the Securityholder of a Security with terms that would preserve for the Securityholder the economic equivalent of any payment or delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of such termination, less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion. The Issuer's obligations under the Securities shall be satisfied in full upon payment of such amount. If the Issuer determines that the relevant Securities shall continue, the Determination Agent may make such adjustment as the Determination Agent, in its sole and absolute discretion, considers appropriate, if any, to any variable relevant to the exercise, settlement, or payment terms of the relevant Securities and/or any other adjustment (including without limitation, the substitution of the Index) which adjustment shall be effective on such date as the Determination Agent shall determine

6.2.1 *Correction of Index Levels:*

If the level of an Index published by the Index Sponsor and which is utilised by the Determination Agent for any calculation or determination (the "**Original Determination**") under the Securities is subsequently corrected and the correction (the "**Corrected Value**") is published by the Index Sponsor by such time as may be specified in the relevant Final Terms (or, if none is so specified, within one Settlement Cycle after the original publication and prior to the final Valuation Date), then the Determination Agent will notify the Issuer and the Fiscal Agent of the Corrected Value as soon as reasonably practicable and shall determine the relevant value (the "**Replacement Determination**") using the Corrected Value. If the result of the Replacement Determination is different from the result of the Original Determination, to the extent that it determines to be necessary, the Determination Agent may adjust any relevant terms accordingly.

6.3 *Adjustments affecting Underlying Securities:*

This Condition 6.3 is applicable only in relation to Securities specified in the relevant Final Terms as being Share Securities or Share Basket Securities.

6.3.1 *Adjustments for Potential Adjustment Events:*

- (a) Following the declaration by the Underlying Security Issuer of the terms of a Potential Adjustment Event, the Determination Agent will determine whether such Potential Adjustment Event has a diluting or concentrative effect on the theoretical value of the relevant Underlying Securities and, if so, will (i) make such adjustment as it in its sole and absolute discretion considers appropriate, if any, to the Strike Price, the formula for the Cash Settlement Amount and/or the Settlement Price and/or the Relevant Price set out in the relevant Final Terms, the number of Underlying Securities to which each Security relates,

the number of Underlying Securities comprised in a Basket, the amount, the number of or type of shares or other securities which may be delivered in respect of such Securities and/or any other adjustment and, in any case, any other variable relevant to the exercise, settlement, payment or other terms of the relevant Securities as the Determination Agent determines, in its sole and absolute discretion, to be appropriate to account for that diluting or concentrative effect and (ii) determine, in its sole and absolute discretion, the effective date(s) of such adjustment(s).

(b) *For the purposes hereof:*

**"Extraordinary Dividend"** means the dividend per Underlying Security, or portion thereof, which the Determination Agent determines should be characterised as an Extraordinary Dividend.

**"Potential Adjustment Event"** means any of the following:

- (i) a subdivision, consolidation or reclassification of relevant Underlying Securities (unless resulting in a Merger Event), or a free distribution or dividend of any such Underlying Securities to existing holders by way of bonus, capitalisation or similar issue; or
- (ii) a distribution, issue or dividend to existing holders of the relevant Underlying Securities of (A) such Underlying Securities, or (B) other share capital or securities granting the right to payment of dividends and/or the proceeds of liquidation of the Underlying Security Issuer equally or proportionately with such payments to holders of such Underlying Securities, or (C) share capital or other securities of another issuer acquired or owned (directly or indirectly) by the Underlying Security Issuer as a result of a spin-off or other similar transaction, or (D) any other type of securities, rights or warrants or other assets, in any case for payment (cash or other consideration) at less than the prevailing market price as determined by the Determination Agent in its sole and absolute discretion; or
- (iii) an Extraordinary Dividend; or
- (iv) a call by the Underlying Security Issuer in respect of relevant Underlying Securities that are not fully paid; or
- (v) a repurchase by the Underlying Security Issuer or any of its subsidiaries of relevant Underlying Securities whether out of profits or capital and whether the consideration for such repurchase is cash, securities or otherwise; or
- (vi) in respect of the Underlying Security Issuer, an event that results in any shareholder rights being distributed or becoming separated from shares of common stock or other shares of the capital stock of the Underlying Security Issuer pursuant to a shareholder rights plan or arrangement directed against hostile takeovers that provides upon the occurrence of certain events for a distribution of preferred stock, Securities, debt instruments or stock rights at a price below their market value, as determined by the Determination Agent in its sole and absolute discretion, provided that any adjustment effected as a result of such an event shall be readjusted upon any redemption of such rights; or

(vii) any other event that may have a diluting or concentrative effect on the theoretical value of the relevant Underlying Securities; or

(viii) any other event specified as such in the relevant Final Terms.

6.3.2 *European currency related adjustments:*

If any relevant Underlying Securities were originally quoted, listed and/or dealt as of the Initial Date in a currency of a member state of the European Union that has not adopted the single currency in accordance with the EC Treaty, and are at any time thereafter quoted, listed and/or dealt exclusively in euro on the Exchange or, where no Exchange is specified in the relevant Final Terms, the principal market on which such Underlying Securities are traded, then the Determination Agent will adjust any amount or quantity that is payable or deliverable in respect of the Securities and/or any other settlement, payment or other terms of the Securities as the Determination Agent determines appropriate to preserve the economic terms of the Securities. The Determination Agent will make any conversion necessary for purposes of any such adjustment as of the Valuation Time at an appropriate mid-market spot rate of exchange determined by the Determination Agent prevailing as of the Valuation Time. No adjustments under this Condition 6.3.2 will affect the currency denomination of any payment obligations of the Issuer under the Securities.

6.3.3 *Correction of Underlying Security Prices:*

If any price published on the Exchange and which is utilised by the Determination Agent for any calculation or determination (the "**Original Determination**") under the Securities is subsequently corrected and the correction (the "**Corrected Value**") is published by the Exchange by such time as may be specified in the relevant Final Terms (or, if none is so specified, within one Settlement Cycle after the original publication and prior to the final Valuation Date), then the Determination Agent will notify the Issuer and the Fiscal Agent of the Corrected Value as soon as reasonably practicable and shall determine the relevant value (the "**Replacement Determination**") using the Corrected Value. If the result of the Replacement Determination is different from the result of the Original Determination, to the extent that it determines to be necessary, the Determination Agent may adjust any relevant terms accordingly.

6.4 *Extraordinary Events:*

This Condition 6.4 is applicable only in relation to Securities specified in the relevant Final Terms as being Share Securities or Share Basket Securities.

6.4.1 *Merger Event or Tender Offer:*

- (a) Following the occurrence of any Merger Event or Tender Offer, the Issuer will, in its sole and absolute discretion, determine whether or not the relevant Securities shall continue.
- (b) If the Issuer determines that the relevant Securities shall continue, the Determination Agent may make such adjustment as the Determination Agent, in its sole and absolute discretion, considers appropriate, if any, to the Strike Price, the formula for the Cash Settlement Amount and/or the Settlement Price and/or the Relevant Price set out in the relevant Final Terms, the number of Underlying Securities to which each Security relates, the number of Underlying Securities comprised in a Basket, the amount, the number of or type of shares or other securities which may be delivered under such Securities and, in any case, any other variable relevant to the exercise, settlement, or payment terms of the relevant Securities

and/or any other adjustment (including without limitation, in relation to Share Basket Securities, the cancellation of terms applicable in respect of Underlying Securities affected by the relevant Merger Event or Tender Offer) which adjustment shall be effective on such date as the Determination Agent shall determine.

- (c) If the Issuer determines that the relevant Securities shall be terminated, then the relevant Securities shall cease to be exercisable as of the Merger Date (in the case of a Merger Event) or Tender Offer Date (in the case of a Tender Offer) (or, in the case of any Securities which have been exercised but remain unsettled, the entitlements of the respective exercising Securityholders to receive Underlying Securities or the Cash Settlement Amount, as the case may be, pursuant to such exercise shall cease) and the Issuer's obligations under the Securities shall be satisfied in full upon payment of the Merger Event Settlement Amount (as defined below) (in the case of a Merger Event) or Tender Offer Settlement Amount (in the case of a Tender Offer).
- (d) For the purposes hereof:

**"Merger Date"** means the closing date of a Merger Event or, where a closing date cannot be determined under the local law applicable to such Merger Event, such other date as determined by the Determination Agent in its sole and absolute discretion.

**"Merger Event"** means in respect of any relevant Underlying Securities, as determined by the Determination Agent, acting in a commercially reasonable manner, any: (i) reclassification or change of such Underlying Securities that results in a transfer of or an irrevocable commitment to transfer all of such Underlying Securities outstanding to another entity or person, (ii) consolidation, amalgamation, merger or binding share exchange of the Underlying Security Issuer with or into another entity or person (other than a consolidation, amalgamation, merger or binding share exchange in which such Underlying Security Issuer is the continuing entity and which does not result in a reclassification or change of all such Underlying Securities outstanding), (iii) takeover offer, tender offer, exchange offer, solicitation, proposal or other event by any entity or person to purchase or otherwise obtain 100% of the outstanding Underlying Securities of the Underlying Security Issuer that results in a transfer of or an irrevocable commitment to transfer all such Underlying Securities (other than such Underlying Securities owned or controlled by such other entity or person), or (iv) consolidation, amalgamation, merger or binding share exchange of the Underlying Security Issuer or its subsidiaries with or into another entity in which the Underlying Security Issuer is the continuing entity and which does not result in a reclassification or change of all such Underlying Securities outstanding but results in the outstanding Underlying Securities (other than Underlying Securities owned or controlled by such other entity) immediately prior to such event collectively representing less than 50% of the outstanding Underlying Securities immediately following such event (a **"Reverse Merger"**), in each case if the Merger Date is on or before, (A) in respect of Securities where settlement by delivery applies, the later to occur of the Expiration Date and the Physical Settlement Date or, (B) in any other case, the final Valuation Date.

**"Merger Event Settlement Amount"** means an amount which the Determination Agent, in its sole and absolute discretion, determines is the fair value to the Securityholder of a Security with terms that would preserve for the Securityholder the economic equivalent of any payment or delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of the Merger Eventless the cost to the Issuer of, or the loss

realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion.

**"Tender Offer"** means, in respect of any Underlying Securities, as determined by the Determination Agent, acting in a commercially reasonable manner, a takeover offer, tender offer, exchange offer, solicitation, proposal or other event by any entity or person that results in such entity or person purchasing, or otherwise obtaining or having the right to obtain, by conversion or other means, greater than 10% and less than 100% of the outstanding voting shares of the Underlying Security Issuer, as determined by the Determination Agent, based upon the making of filings with governmental or self-regulatory agencies or such other information as the Determination Agent deems relevant.

**"Tender Offer Date"** means, in respect of a Tender Offer, the date on which voting shares in the amount of the applicable percentage threshold are actually purchased or otherwise obtained, as determined by the Determination Agent in its sole and absolute discretion.

**"Tender Offer Settlement Amount"** means an amount which the Determination Agent, in its sole and absolute discretion, determines is the fair value to the Securityholder of a Security with terms that would preserve for the Securityholder the economic equivalent of any payment or delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of the Tender Offer, less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion.

#### 6.4.2 *Nationalisation, Insolvency and Delisting:*

- (a) If in the determination of the Determination Agent, acting in a commercially reasonable manner:
- (1) all the Underlying Securities or all or substantially all the assets of the Underlying Security Issuer are nationalised, expropriated or are otherwise required to be transferred to any governmental agency, authority, entity or instrumentality thereof ("**Nationalisation**"); or
  - (2) by reason of the voluntary or involuntary liquidation, bankruptcy or insolvency, dissolution or winding-up of or any analogous proceeding affecting a Underlying Security Issuer, (1) all the Underlying Securities of that Underlying Security Issuer are required to be transferred to a trustee, liquidator or other similar official or (2) holders of the Underlying Securities of that Underlying Security Issuer become legally prohibited from transferring them ("**Insolvency**"); or
  - (3) the Exchange announces that pursuant to the rules of such Exchange, the Underlying Securities cease (or will cease) to be listed, traded or publicly quoted on the Exchange for any reason (other than a Merger Event or Tender Offer) and are not immediately re-listed, re-traded or re-quoted on an exchange or quotation system located in the same country as the Exchange (or, where the Exchange is within the European Union, in any member state of the European Union) ("**Delisting**"),

then the Issuer will, in its sole and absolute discretion, determine whether or not the Securities shall continue.

- (b) If the Issuer determines that the relevant Securities shall continue, the Determination Agent may make such adjustment as the Determination Agent, in its sole and absolute discretion, considers appropriate, if any, to the Strike Price, the formula for the Cash Settlement Amount and/or the Settlement Price and/or the Relevant Price set out in the relevant Final Terms, the number of Underlying Securities to which each Security relates, the number of Underlying Securities comprised in a Basket, the amount, the number of or type of shares or other securities which may be delivered under such Securities and, in any case, any other variable relevant to the exercise, settlement, or payment terms of the relevant Securities and/or any other adjustment (including without limitation, in relation to Share Basket Securities or Index Basket Securities, the cancellation of terms applicable in respect of Underlying Securities or any Index, as the case may be, affected by the relevant Additional Disruption Event) which change or adjustment shall be effective on such date as the Determination Agent shall determine.
- (c) If the Issuer determines that the relevant Securities shall be terminated, then the relevant Securities shall cease to be exercisable (or, in the case of any Securities which have been exercised but remain unsettled, the entitlements of the respective exercising Securityholders to receive Underlying Securities or the Cash Settlement Amount, as the case may be, pursuant to such exercise shall cease) as of the Announcement Date and the Issuer's obligations under the Securities shall be satisfied in full upon payment of an amount which the Determination Agent, in its sole and absolute discretion, determines is the fair value to the Securityholder of a Security with terms that would preserve for the Securityholder the economic equivalent of any payment or delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of such Nationalisation, Insolvency or Delisting, less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion.
- (d) For the purposes hereof, "**Announcement Date**" means, as determined by the Determination Agent in its sole and absolute discretion: (i) in the case of a Nationalisation, the date of the first public announcement to nationalise (whether or not subsequently amended) that leads to the Nationalisation, (ii) in the case of an Insolvency, the date of the first public announcement of the institution of a proceeding or presentation of a petition or passing of a resolution (or other analogous procedure in any jurisdiction) that leads to the Insolvency and (iii) in the case of a Delisting, the date of the first public announcement by the Exchange that the Underlying Securities will cease to be listed, traded or publicly quoted in the manner described in (a)(iii) above. In respect of any such event, if the announcement of such event is made after the actual closing time for the regular trading session on the relevant Exchange, without regard to any after hours or any other trading outside of regular trading session hours, the Announcement Date shall be deemed to be the next following Scheduled Trading Day.

#### 6.5 *Additional Disruption Events*

- (a) Following the occurrence of an Additional Disruption Event, the Issuer will, in its sole and absolute discretion, determine whether or not the relevant Securities shall continue.

- (b) If the Issuer determines that the relevant Securities shall continue, the Determination Agent may make such adjustment as the Determination Agent, in its sole and absolute discretion, considers appropriate, if any, to the Strike Price, the formula for the Cash Settlement Amount and/or the Settlement Price and/or the Relevant Price set out in the relevant Final Terms, the number of Underlying Securities to which each Security relates, the number of Underlying Securities comprised in a Basket, the amount, the number of or type of shares or other securities which may be delivered under such Securities and, in any case, any other variable relevant to the exercise, settlement, or payment terms of the relevant Securities and/or any other adjustment (including without limitation, in relation to Share Basket Securities or Index Basket Securities, the cancellation of terms applicable in respect of any Underlying Securities or Index, as the case may be, affected by the relevant Additional Disruption Event) which change or adjustment shall be effective on such date as the Determination Agent shall determine.
- (c) If the Issuer determines that the relevant Securities shall be terminated, then the relevant Securities shall cease to be exercisable (or, in the case of any Securities which have been exercised but remain unsettled, the entitlements of the respective exercising Securityholders to receive Underlying Securities or the Cash Settlement Amount, as the case may be, pursuant to such exercise shall cease) and the Issuer's obligations under the Securities shall be satisfied in full upon payment of an amount which the Determination Agent, in its sole and absolute discretion, determines is the fair value to the Securityholder of a Security with terms that would preserve for the Securityholder the economic equivalent of any payment or delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of such termination, less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion.
- (d) The Issuer shall as soon as reasonably practicable under the circumstances notify the Fiscal Agent and the Determination Agent of the occurrence of an Additional Disruption Event.

6.6 In relation to Share Securities, Share Basket Securities, Index Securities or Index Basket Securities, the following expressions have the meanings set out below:

**"Additional Disruption Event"** means with respect to a series of Share Securities or Share Basket Securities (unless specified in the relevant Final Terms) a Change of Law, Hedging Disruption, Increased Cost of Hedging or Loss of Stock Borrow (as defined below), and any further event or events specified in the applicable Final Terms as an Additional Disruption Event applicable with respect to such Securities.

**"Basket"** means:

- (i) in respect of an Index Basket Security, a basket composed of each Index specified in the relevant Final Terms in the relative proportions specified in such Final Terms; and
- (ii) in respect of a Share Basket Security and a Bond Security, a basket composed of Underlying Securities of each Underlying Security Issuer specified in the relevant Final Terms in the relative proportions or number of Underlying Securities of each Underlying Security Issuer specified in such Final Terms;

**"Change in Law"** means that, on or after the Initial Date (A) due to the adoption of or any change in any applicable law or regulation (including, without limitation, any tax law), or (B) due to the promulgation of or any change in the interpretation by any court, tribunal or regulatory authority with competent jurisdiction of any applicable law or regulation (including any action taken by a taxing authority), the Issuer determines

in good faith that (X) it has become illegal for the Issuer or an Affiliate to hold, acquire or dispose of Shares relating to the relevant Securities, or (Y) the Issuer and/or (in the case of any related hedging transaction) an Affiliate will incur a materially increased cost in performing its obligations under the relevant Securities or any related hedging transaction (including, without limitation, due to any increase in tax liability, decrease in tax benefit or other adverse effect on its tax position) and the Issuer or such Affiliate is unable, after using commercially reasonable efforts, to effect or acquire any alternative transaction(s) or asset(s) the Issuer deems necessary to hedge the equity or other price risk of entering into and performing its obligations with respect to the relevant Securities and which will enable the Issuer or its Affiliate to avoid such illegality or material increased cost;

**"Component"** means, in respect of an Index, any securities comprising such Index;

**"Exchange"** means (1) in respect of an Underlying Security relating to a Share Security or Share Basket Security or an Index relating to an Index Security or Index Basket Security other than a Multi-exchange Index, each exchange or quotation system specified as such for the relevant Underlying Security or Index in the relevant Final Terms, any successor to such exchange or quotation system or any substitute exchange or quotation system to which trading in the relevant Underlying Security (in the case of a Share Security or Share Basket Security) or the securities comprised in the relevant Index (in the case of an Index Security or Index Basket Security) has temporarily relocated (provided that the Determination Agent has determined that there is comparable liquidity relative to such Underlying Security or, as the case may be, the securities comprised in such Index on such temporary substitute exchange or quotation system as on the original Exchange) or if none is specified, the principal exchange or quotation system for trading in such Underlying Security or Index, as determined by the Determination Agent, and (2) in respect of a Multi-exchange Index, and in respect of each Component, the principal stock exchange on which such Component is principally traded, as determined by the Determination Agent;

**"Exchange Business Day"** means (1) (other than with respect to an Index Security or Index Basket Security relating to a Multi-exchange Index), any Scheduled Trading Day on which each Exchange and each Related Exchange are open for trading during their respective regular trading sessions, notwithstanding any such Exchange or Related Exchange closing prior to its Scheduled Closing Time or (2) with respect to an Index Security or Index Basket Security relating to a Multi-exchange Index, any Scheduled Trading Day on which (a) the Index Sponsor publishes the level of the Index and (b) the Related Exchange is open for trading during its regular trading session, notwithstanding that any Exchange or Related Exchange closing prior to its Scheduled Closing Time;

**"Hedging Disruption"** means that the Issuer or an Affiliate is unable, after using commercially reasonable efforts, to (A) acquire, establish, re-establish, substitute, maintain, unwind or dispose of any transaction(s) or asset(s) which the Issuer deems necessary to hedge the equity or other price risk of entering into and performing its obligations with respect to the relevant Securities, or (B) realize, recover or remit the proceeds of any such transaction(s) or asset(s);

**"Increased Cost of Hedging"** means that the Issuer would incur a materially increased (as compared with circumstances existing on the Initial Date) amount of tax, duty, expense or fee (other than brokerage commissions) to (A) acquire, establish, re-establish, substitute, maintain, unwind or dispose of any transaction(s) or asset(s) it deems necessary to hedge the risk of entering into and performing its obligations with respect to the Securities or (B) realise, recover or remit the proceeds of any such transaction(s) or asset(s) provided that any such materially increased amount that is incurred solely due to the deterioration of the creditworthiness of the Issuer shall not be deemed an Increased Cost of Hedging;

**"Index"** means, in respect of any Index Security or Index Basket Security and subject to Condition 6.2 (*Adjustments to Indices*), each index specified as such in the relevant Final Terms;

**"Index Sponsor"** means, in respect of an Index, the corporation or other entity that (a) is responsible for setting and reviewing the rules and procedures and the methods of calculation and adjustments, if any, related to the relevant Index and (b) announces (directly or through an agent) the level of the relevant Index on a regular basis during each Scheduled Trading Day;

**"Loss of Stock Borrow"** means that the Issuer or an Affiliate is unable, after using commercially reasonable efforts, to borrow (or maintain a borrowing of) Shares with respect to the relevant Securities in an amount which the Issuer deems necessary to hedge the risk of entering into and performing its obligations with respect to the Securities (not to exceed the number of Shares underlying the Securities) at a rate as determined by the Issuer;

**"Multi-exchange Index"** means any Index specified as such in the relevant Final Terms;

**"Related Exchange"** means, subject to the proviso below, in respect of an Underlying Security relating to a Share Security or Share Basket Security or an Index relating to an Index Security or Index Basket Security, each exchange or quotation system specified as such for such Underlying Security or Index in the relevant Final Terms, any successor to such exchange or quotation system or any substitute exchange or quotation system to which trading in futures or options contracts relating to such Underlying Security or such Index has temporarily relocated (provided that the Determination Agent has determined that there is comparable liquidity relative to the futures or options contracts relating to such Underlying Security or such Index on such temporary substitute exchange or quotation system as on the original Related Exchange), provided, however, that where **"All Exchanges"** is specified as the Related Exchange in the relevant Final Terms, "Related Exchange" shall mean each exchange or quotation system where trading has a material effect (as determined by the Determination Agent) on the overall market for futures or options contracts relating to such Underlying Security or such Index;

**"Relevant Price"** on any day means:

- (i) in respect of an Underlying Security to which a Share Security or a Share Basket Security relates, the price per Underlying Security determined by the Determination Agent as provided in the relevant Final Terms as of the Valuation Time on the Valuation Date or Averaging Date, as the case may be, or, if no means for determining the Relevant Price are so provided: (a) in respect of any Underlying Security for which the Exchange is an auction or "open outcry" exchange that has a price as of the Valuation Time at which any trade can be submitted for execution, the Relevant Price shall be the price per Underlying Security as of the Valuation Time on the Valuation Date or Averaging Date, as the case may be, as reported in the official real-time price dissemination mechanism for such Exchange; and (b) in respect of any Underlying Security for which the Exchange is a dealer exchange or dealer quotation system, the Relevant Price shall be the mid-point of the highest bid and lowest ask prices quoted as of the Valuation Time on the Valuation Date or Averaging Date, as the case may be, (or the last such prices quoted immediately before the Valuation Time) without regard to quotations that "lock" or "cross" the dealer exchange or dealer quotation system;
- (ii) in respect of an Index to which an Index Security or an Index Basket Security relates, the level of such Index determined by the Determination Agent as provided in the relevant Final Terms as of the Valuation Time on the Valuation Date or Averaging Date, as the case may be, or, if no means for determining the Relevant Price are so provided, the level of the Index as of the Valuation Time on the Valuation Date or Averaging Date, as the case may be;

**"Scheduled Closing Time"** means, in respect of an Exchange or Related Exchange and a Scheduled Trading Day, the scheduled weekday closing time of such Exchange or Related Exchange on such Scheduled Trading Day, without regard to after hours or any other trading outside of the regular trading session hours;

**"Scheduled Trading Day"** means (1) except with respect to a Multi-exchange Index, any day on which each Exchange and each Related Exchange are scheduled to be open for trading for their respective regular trading sessions and (2) with respect to a Multi-exchange Index, any day on which (a) the Index Sponsor is scheduled to publish the level of the Index and (b) the Related Exchange is scheduled to be open for trading for its regular trading session;

**"Settlement Price"** means, in respect of a Share Security, a Share Basket Security, an Index Security or an Index Basket Security, the price, level or amount as determined by the Determination Agent, in its sole and absolute discretion, in accordance with the relevant Final Terms; and

**"Valuation Time"** means in respect of Share Securities, Share Basket Securities, Index Securities or Index Basket Securities, the time on the relevant Valuation Date or Averaging Date, as the case may be, specified as such in the relevant Final Terms or, if no such time is specified, the Scheduled Closing Time on the relevant Exchange in relation to each Underlying Security or Index to be valued. If the relevant Exchange closes prior to its Scheduled Closing Time and the specified Valuation Time is after the actual closing time for its regular trading session, then the Valuation Time shall be such actual closing time.

## 7. PROVISIONS RELATING TO BOND SECURITIES

This Condition 7 is applicable only in relation to Securities specified in the relevant Final Terms as being Bond Securities.

### 7.1 *Conversion:*

7.1.1 Following the occurrence of any Conversion, the Issuer will, in its sole and absolute discretion, determine whether or not the Securities will continue and, if so, the Determination Agent will determine, in its sole and absolute discretion, any adjustments to be made.

7.1.2 If the Issuer determines that the Securities shall continue, the Determination Agent may make such adjustment as it, in its sole and absolute discretion considers appropriate, to the Strike Price, the formula for the Cash Settlement Amount set out in the relevant Final Terms, the Bond Security Entitlement, the number of Underlying Securities to which each Security relates, the number of Underlying Securities comprised in a Basket, the amount, number of or type of bonds or other debt securities which may be delivered under such Securities and, in any case, any other variable relevant to the exercise, settlement, or payment terms of the relevant Securities and/or any other adjustment and determine, in its sole and absolute discretion, the effective date(s) of such adjustment.

7.1.3 If the Issuer determines that the Securities shall be terminated, then the Securities shall cease to be exercisable (or, in the case of any Securities which have been exercised, the entitlements of the respective exercising Securityholders to receive Underlying Securities or the Cash Settlement Amount, as the case may be, pursuant to such exercise, shall cease) and the Issuer's obligations under the Securities shall be satisfied in full upon payment of the Conversion Settlement Amount.

7.1.4 For the purposes hereof:

"**Conversion**" means, as determined by the Determination Agent, acting in a commercially reasonable manner, in respect of any relevant Underlying Securities any irreversible conversion by the Underlying Security Issuer, of such Underlying Securities into other securities.

"**Conversion Settlement Amount**" means an amount which the Determination Agent, acting in a commercially reasonable manner, determines is the fair value to the Securityholder of a Security with terms that would preserve the economic equivalent of any payment or delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the Security but for the occurrence of the Conversion, less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion.

## 7.2 *Correction to published prices*

For the purposes of determining the Spot Price for any day, if applicable, as specified in the relevant Final Terms for the purposes of calculating the Cash Settlement Amount or any other amount in respect of a Bond Security, if the price published or announced on a given day and used or to be used by the Determination Agent to determine a Spot Price is subsequently corrected and the correction is published or announced by the person responsible for that publication or announcement by such time as may be specified in the relevant Final Terms (or, if none is so specified, within thirty days of the original publication or announcement, and the Determination Agent determines (in its sole and absolute discretion) that an amount is repayable to the Issuer as a result of that correction, the Issuer shall be entitled to reimbursement of the relevant payment by the relevant Securityholder, together with interest on that amount at a rate per annum equal to the cost (without proof or evidence of actual cost) to the Issuer of funding that amount for the period from and including the day on which a payment originally was made, to but excluding the day of payment of the refund or payment resulting from that correction (all as determined by the Determination Agent in its sole and absolute discretion). Any such reimbursement shall be effected in such manner as the Issuer shall agree with the Principal Securities Agent and shall be notified to the relevant Securityholder(s) by facsimile or telex to the number specified in the relevant Exercise Notice.

7.3 In relation to Bond Securities, the following expressions have the meanings set out below:

"**Exchange**" means each securities exchange or trading market specified as such in the relevant Final Terms (including any successor to that securities exchange or trading market) for so long as the Underlying Securities are listed or otherwise included in that securities exchange or trading market. If the specified Exchange ceases to list or otherwise include the Underlying Securities and the Underlying Securities are listed or otherwise included in any other securities exchange or trading market, the Determination Agent will, in its sole and absolute discretion, select an alternative securities exchange or trading market;

"**Exchange Business Day**" means in respect of any Bond Security, any day that is a trading day on the Exchange (or on each Exchange if more than one is specified) other than a day on which trading on the Exchange is scheduled to close prior to its regular weekday closing time;

"**Spot Price**" means, in respect of any Bond Security:

- (i) if the Strike Price is stated as an amount in the relevant currency, the price for the Underlying Securities, stated as an amount in the relevant currency, equal in amount to the nominal amount (the "**Bond Security Entitlement**") specified in the relevant Final Terms of the relevant Underlying Securities to which one Security relates; and

- (ii) if the Strike Price is stated as a percentage of the nominal value of the Underlying Securities, the price of the Underlying Securities stated as a percentage of their nominal value,
- (iii) in each case, as of the Valuation Time on the relevant Exercise Date, as determined by the Determination Agent in its sole and absolute discretion; and

"**Valuation Time**" means in the case of Bond Securities, the time specified as such in the relevant Final Terms.

## 8. PROVISIONS RELATING TO CURRENCY SECURITIES

This Condition 8 is applicable only in relation to Securities specified in the relevant Final Terms as being Currency Securities.

8.1 *Valuation Date*: "**Valuation Date**" means, in respect of any Series of Currency Securities, the date(s) specified as such in the relevant Final Terms provided that where the Valuation Date is not a Currency Business Day then the Valuation Date shall be the first preceding day that is a Currency Business Day, unless otherwise specified in the relevant Final Terms. Unless otherwise specified in the relevant Final Terms and subject to Condition 8.2 (*Averaging*), the Valuation Date will be the two Currency Business Days prior to the Exercise Date.

8.2 *Averaging*: If Averaging Dates are specified in the relevant Final Terms, then notwithstanding any other provisions of these Conditions, the following provisions will apply to the determination of the Settlement Rate in relation to a Valuation Date:

8.2.1 "**Averaging Date**" means, in respect of a Valuation Date, each date specified as such or otherwise determined as provided in the relevant Final Terms, provided that if any such date is not a Currency Business Day, such date shall be the first preceding day that is a Currency Business Day, unless otherwise specified in the relevant Final Terms.

8.2.2 For purposes of determining the Settlement Rate in relation to a Valuation Date, the Settlement Rate will be the arithmetic mean of the Spot Rates on each Averaging Date (or, if different, the day on which rates for each Averaging Date would, in the ordinary course, be published or announced by the relevant price source).

8.2.3 Unless otherwise specified in the relevant Final Terms, in the case where it becomes impossible to obtain the Spot Rate on an Averaging Date (or, if different, the day on which rates for that Averaging Date would, in the ordinary course, be published or announced by the relevant price source), such Averaging Date will be deemed not to be a relevant Averaging Date for purposes of determining the relevant Settlement Rate. If through the operation of this Condition 8.2.3, there would not be an Averaging Date with respect to the relevant Valuation Date, the provisions of Conditions 8.3 (*Currency Disruption Events*) and 8.4 (*Currency Disruption Fallbacks*) shall apply for purposes of determining the relevant Spot Rate on the final Averaging Date with respect to that Valuation Date as if such Averaging Date were a Valuation Date on which a Price Source Disruption had occurred.

8.3 *Currency Disruption Events*:

8.3.1 If so specified in the Final Terms relating to any Series of Securities, the following shall constitute "Currency Disruption Events" for the purposes of such Series:

- (a) "**Price Source Disruption**", which means it becomes impossible, as determined by the Determination Agent, acting in a commercially reasonable manner, to determine the

Settlement Rate on the Valuation Date (or, if different, the day on which rates for that Valuation Date would, in the ordinary course, be published or announced by the relevant price source in accordance with the relevant price source); and

(b) any other (if any) currency disruption event specified in the relevant Final Terms.

8.3.2 If the relevant Final Terms specifies that any Currency Disruption Event shall be applicable to such Series, then, where the Determination Agent determines, acting in a commercially reasonable manner, that such Currency Disruption Event has occurred and is continuing in respect of such Series:

(a) in the case of Price Source Disruption, on the day that is the Valuation Date in respect of such Series (or, if different, the day on which rates for that Valuation Date would, in the ordinary course, be published or announced by the relevant price source); and

(b) in the case of any other Currency Disruption Event, on such day as may be specified for this purpose in the relevant Final Terms,

then the Settlement Rate for such Series will be determined, or the Securities of such Series shall be settled following exercise, as the case may be, in accordance with the terms of the Currency Disruption Fallback first applicable pursuant to Condition 8.4 (*Currency Disruption Fallbacks*).

#### 8.4 *Currency Disruption Fallbacks:*

8.4.1 If so specified in the Final Terms relating to any Series of Securities, the following shall constitute "Currency Disruption Fallbacks" for the purposes of such Series, and the relevant Final Terms shall specify which Currency Disruption Fallback(s) shall apply to such Series, to which Currency Disruption Event each such Currency Disruption Fallback shall apply and, where more than one Currency Disruption Fallback may apply to a Currency Disruption Event, the order in which such Currency Disruption Fallback(s) shall apply to such Currency Disruption Event.

(a) "**Determination Agent Determination of Settlement Rate**" means that the Determination Agent will determine, in its sole and absolute discretion, the Settlement Rate (or a method for determining the Settlement Rate), taking into consideration all available information that it deems relevant;

(b) "**Fallback Reference Price**" means, in respect of Price Source Disruption or any other Currency Disruption Event, that the Determination Agent will determine, in its sole and absolute discretion, the Settlement Rate for such Series on the relevant Valuation Date (or, if different, the day on which rates for that Valuation Date would, in the ordinary course, be published or announced) pursuant to the Settlement Rate Option referred to as Currency-Reference Dealers (save that, if so specified in the relevant Final Terms, the reference in the definition of Currency-Reference Dealers to the Cash Settlement Payment Date shall be a reference to such date as is specified for such purpose in the relevant Final Terms) or pursuant to such other Settlement Rate Option as may be specified in the relevant Final Terms; and

(c) any other currency disruption fallbacks specified in the relevant Final Terms.

8.4.2 Where more than one Currency Disruption Event occurs or exists or is deemed to occur or exist, then, unless the relevant Final Terms has specified which Currency Disruption Fallback shall

apply in such circumstances, the Determination Agent shall determine, in its sole and absolute discretion, which Currency Disruption Fallback shall apply.

8.5 In relation to Currency Securities, the following expressions have the meanings set out below:

"**Basket**" means a basket composed of each Reference Currency specified in the relevant Final Terms;

"**Currency Business Day**" means, unless otherwise specified in the relevant Final Terms, for the purposes of:

- (i) the definition of Cash Settlement Payment Date, in respect of any Series of Securities: any day (1) that is neither a legal holiday nor a day on which banking institutions are authorized or required by law or regulation to close (x) in The City of New York or London, or (y) in relation to sums payable in currencies other than U.S. dollars, euro or Australian dollars, in the principal financial centre of the country of the relevant currency, (z) in relation to sums payable in Australian dollars, in Sydney and (2) in relation to sums payable in euro, a day that is also a TARGET Settlement Day;
- (ii) the definition of Valuation Date in Condition 8.1 (*Valuation Date*), in respect of any Currency Security: (1) a day on which commercial banks are open for general business (including dealings in foreign exchange and foreign currency deposits) in the Principal Financial Centre(s) or (2) where the currency to be valued is euro, a day that is a TARGET Settlement Day and a Business Day; and
- (iii) the definition of Exercise Date, Exercise Period and Expiration Date, in respect of any Currency Security: (1) a day on which commercial banks are open for general business (including dealings in foreign exchange in accordance with the market practice of the foreign exchange market) in the Principal Financial Centre(s) and (2) where one of the Currency Pair is euro, a day that is a TARGET Settlement Day;

"**Currency Pair**" means, in respect of any Currency Security, the Reference Currency and the Settlement Currency;

"**Currency-Reference Dealers**", in respect of any Currency Security, is a Settlement Rate Option which means that the Spot Rate for a Rate Calculation Date will be determined on the basis of quotations provided by Reference Dealers on that Rate Calculation Date of that day's Specified Rate, expressed as the amount of Reference Currency per one unit of Settlement Currency for the purposes of calculating the Cash Settlement Amount. The Determination Agent will request the Specified Office of each of the Reference Dealers to provide a firm quotation of its Specified Rate for a transaction where the amount of Reference Currency equals the Specified Amount. If four quotations are provided, the rate for a Rate Calculation Date will be the arithmetic mean of the Specified Rates, without regard to the Specified Rates having the highest and lowest value. If exactly three quotations are provided, the rate for a Rate Calculation Date will be the Specified Rate provided by the Reference Dealer that remains after disregarding the Specified Rates having the highest and lowest values. For this purpose, if more than one quotation has the same highest value or lowest value, then the Specified Rate of one of such quotations shall be disregarded. If exactly two quotations are provided, the rate for a Rate Calculation Date will be the arithmetic mean of the Specified Rates. If only one quotation is provided, the rate for a Rate Calculation Date will be the Specified Rate quoted by that Reference Dealer. The quotations used to determine the Spot Rate for a Rate Calculation Date will be determined in each case at the Specified Time on that Rate Calculation Date or, if no such time is specified, the time chosen by the Determination Agent;

**"Rate Calculation Date"** means any Valuation Date or Averaging Date (as defined in Conditions 8.1 (*Valuation Date*) and 8.2 (*Averaging*) respectively);

**"Reference Currency"** means the currency specified as such in the relevant Final Terms;

**"Reference Currency Jurisdiction"** means the jurisdiction specified as such in the relevant Final Terms;

**"Settlement Rate"** means the rate as determined by the Determination Agent, in its sole and absolute discretion, in accordance with the relevant Final Terms and, where applicable shall be determined in accordance with Condition 8.2 (*Averaging*);

**"Settlement Rate Option"** means for the purposes of calculating the Settlement Rate, the Settlement Rate Option specified in the relevant Final Terms (or deemed specified pursuant to Condition 8.4 (*Currency Disruption Fallbacks*));

**"Specified Amount"** means the amount of Reference Currency specified as such in the relevant Final Terms;

**"Specified Rate"** means any of the following rates, as specified in the relevant Final Terms: (i) the Reference Currency bid exchange rate, (ii) the Reference Currency offer exchange rate, (iii) the average of the Reference Currency bid and offer exchange rates, (iv) the Settlement Currency bid exchange rate, (v) the Settlement Currency offer exchange rate, (vi) the average of the Settlement Currency bid and offer exchange rates, (vii) the official fixing rate or (viii) any other exchange rate specified in the relevant Final Terms. If no such rate is specified, the Specified Rate will be deemed to be the average of the Reference Currency bid and offer rate; and

**"Spot Rate"** means for any Valuation Date thereof, the relevant currency exchange rate determined in accordance with the specified (or deemed specified) Settlement Rate Option and, if a Settlement Rate Option is not specified (or deemed specified), the currency exchange rate at the time at which such rate is to be determined for foreign exchange transactions in the Currency Pair for value on the relevant Valuation Date, as determined in good faith and in a commercially reasonable manner by the Determination Agent.

## 9. PROVISIONS RELATING TO COMMODITY SECURITIES

This Condition 9 is applicable only in relation to Securities specified in the relevant Final Terms as being Commodity Securities.

- 9.1 *Corrections to published prices:* For the purposes of determining the Relevant Price for any Pricing Date, if applicable, as specified in the relevant Final Terms for the purposes of calculating the Cash Settlement Amount or any other amount in respect of a Commodity Security, if the price published or announced on a given day and used or to be used by the Determination Agent to determine such Relevant Price is subsequently corrected and the correction is published or announced by the person responsible for that publication or announcement by such time as may be specified in the relevant Final Terms (or, if none is so specified, within thirty days of the original publication or announcement, and the Determination Agent determines (in its sole and absolute discretion) that an amount is repayable to the Issuer as a result of that correction, the Issuer shall be entitled to reimbursement of the relevant payment by the relevant Securityholder, together with interest on that amount at a rate per annum equal to the cost (without proof or evidence of actual cost) to the Issuer of funding that amount for the period from and including the day on which a payment originally was made, to but excluding the day of payment of the refund or payment resulting from that correction (all as determined by the Determination Agent in its sole and absolute discretion). Any such reimbursement shall be effected in such manner as the Issuer shall agree with the

Principal Securities Agent and shall be notified to the relevant Securityholder(s) by facsimile or telex to the number specified in the relevant Exercise Notice.

9.2 *Commodity Disruption Events:*

9.2.1 If so specified in the Final Terms relating to any Series of Commodity Securities, the following shall constitute "Commodity Disruption Events" for the purposes of such Series:

- (a) "**Price Source Disruption**", which means (i) the failure of the Price Source to announce or publish the Specified Price (or the information necessary for determining the Specified Price) for the relevant Commodity Reference Price, (ii) the temporary or permanent discontinuance or unavailability of the Price Source, (iii) if the Commodity Reference Price is "Commodity-Reference Dealers," the failure to obtain at least three quotations from the relevant Reference Dealers or (iv) if Price Materiality Percentage is specified in the applicable Final Terms, the Specified Price for the relevant Commodity Reference Price differs from the Specified Price determined in accordance with the Commodity Reference Price "Commodity-Reference Dealers" by such Price Materiality Percentage;
- (b) "**Trading Disruption**", which means the material suspension of, or the material limitation imposed on, trading in the Futures Contract or the Commodity on the Exchange or in any additional futures contract, options contract or commodity on any Exchange as specified in the applicable Final Terms. The determination of whether a suspension of or limitation on trading is material shall be made by the Determination Agent in its sole and absolute discretion;
- (c) "**Disappearance of Commodity Reference Price**", which means (i) the permanent discontinuation of trading in the relevant Futures Contract on the relevant Exchange or (ii) the disappearance of, or of trading in, the relevant Commodity or (iii) the disappearance or permanent discontinuance or unavailability of a Commodity Reference Price, notwithstanding the availability of the related Price Source or the status of trading in the relevant Futures Contract or the relevant Commodity;;
- (d) "**Material Change in Content**", which means the occurrence since the Initial Date of a material change in the content, composition or constitution of the relevant Commodity or relevant Futures Contract;
- (e) "**Material Change in Formula**", which means the occurrence since the Initial Date of a material change in the formula for or method of calculating the relevant Commodity Reference Price;
- (f) "**Tax Disruption**", which means the imposition of, change in or removal of an excise, severance, sales, use, value-added, transfer, stamp, documentary, recording or similar tax on, or measure by reference to, the relevant Commodity (other than a tax on, or measured by reference to, overall gross or net income) by any government or taxation authority after the Initial Date, if the direct effect of such imposition, change or removal is to raise or lower the Relevant Price on the day that would otherwise be a Pricing Date from what it would have been without that imposition, change or removal;
- (g) "**Trading Limitation**", which means the material limitation imposed on trading in the Futures Contract or the Commodity on the Exchange or in any additional futures contract, options contract or commodity on any exchange or principal trading market as specified in the relevant Final Terms; and

(h) any other (if any) commodity disruption event specified in the relevant Final Terms.

9.2.2 If the relevant Final Terms specifies that any Commodity Disruption Event shall be applicable to such Series, then, where the Determination Agent determines, acting in a commercially reasonable manner, that such Commodity Disruption Event has occurred and is continuing in respect of such Series on the Pricing Date in respect of such Series (or, if different, the day on which prices for that Pricing Date would, in the ordinary course, be published or announced by the Price Source), or on any other day as may be specified for this purpose in the relevant Final Terms, then the Relevant Price will be determined, or the Securities of such Series shall be settled following exercise, as the case may be, in accordance with the terms of the Commodity Disruption Fallback first applicable pursuant to Condition 9.3 (*Commodity Disruption Fallbacks*).

9.3 *Commodity Disruption Fallbacks:*

Where one or more Commodity Disruption Events occurs or exists, then unless the relevant Final Terms specifies that any other Commodity Disruption Fallback shall apply in respect of any Commodity Disruption Event, "Determination Agent Determination" shall apply.

"**Determination Agent Determination**" means that the Determination Agent will determine, in its sole and absolute discretion, the Relevant Price (or a method for determining the Relevant Price), taking into consideration the latest available quotation for the relevant Commodity Reference Price and any other information that it deems relevant.

9.4 *Common Pricing:*

With respect to Securities relating to a Basket of Commodities, if "Common Pricing" has been selected in the applicable Final Terms as:

- (i) "Applicable", then no date will be a Pricing Date unless such date is a day on which all referenced Commodity Reference Prices (for which such date would otherwise be a Pricing Date) are scheduled to be published or announced, as determined as of the time of issue of the Securities.
- (ii) "Inapplicable", then if the Determination Agent determines that a Commodity Disruption Event has occurred or exists on the Pricing Date in respect of any Commodity in the Basket (the "**Affected Commodity**"), the Relevant Price of each Commodity within the basket which is not affected by the occurrence of a Commodity Disruption Event shall be determined on its scheduled Pricing Date and the Relevant Price for each Affected Commodity shall be determined in accordance with the first applicable Commodity Disruption Fallback that provides a Commodity Reference Price.

9.5 *Commodity Index Disruption Events:*

9.5.1 The following shall constitute "**Commodity Index Disruption Events**" for the purposes of any Series of Securities with respect to a Commodity Index:

- (a) a temporary or permanent failure by the applicable exchange or other price source to announce or publish the final settlement price for the Commodity Index; or
- (b) the occurrence in respect of any Component of the relevant Commodity Index of a Commodity Disruption Event (as defined in Condition 9.2.1)a material limitation, suspension or disruption of trading in one or more of the Futures Contracts included in the Commodity Reference Price which results in a failure by the exchange on which each

applicable Futures Contract is traded to report a closing price for such contract on the day on which such event occurs or any succeeding day on which it continues.

9.5.2 Where the Determination Agent determines, acting in a commercially reasonable manner, that a Commodity Index Disruption Event has occurred and is continuing in respect of a Series on the Pricing Date in respect of such Series (or, if different, the day on which prices for that Pricing Date would, in the ordinary course, be published or announced by the Price Source), or on any other day as may be specified for this purpose in the relevant Final Terms, then (unless Condition 9.5.3 (*Physical Hedging Fallback*) is specified to apply) the following provisions shall apply:

- (a) with respect to each Component which is not affected by the Commodity Index Disruption Event, the Relevant Price will be determined by the Determination Agent based on the closing prices of each Component on the applicable Pricing Date;
- (b) with respect to each Component which is affected by the Commodity Index Disruption Event, the Relevant Price will be determined by the Determination Agent (in the case of any Dow Jones-AIG Commodity Index) as set out in the DJ-AIGCI Manual or (in the case of any GS Commodity Index) as set out in the GSCI Manual, and in respect of any other Commodity Index as set out in the applicable Final Terms, in each case based on the closing prices of each such Component on the first day following the applicable Pricing Date on which no Commodity Index Disruption Event occurs with respect to such Component;
- (c) subject to (d) below, the Determination Agent shall determine the Relevant Price by reference to the closing prices determined in (a) and (b) above using the then-current method for calculating the relevant Commodity Index; and
- (d) where a Commodity Index Disruption Event with respect to one or more Components continues to exist (measured from and including the first day following the applicable determination date) for five consecutive Trading Days, the Determination Agent shall determine the Relevant Price acting in good faith and in a commercially reasonable manner. In calculating the Relevant Price as set out in this paragraph, the Determination Agent shall use the formula for calculating the relevant Commodity Index last in effect prior to the Commodity Index Disruption Event. For the purposes of this paragraph (d), "**Trading Day**" shall mean a day when the exchanges for all Futures Contracts included in the relevant Commodity Index are scheduled to be open for trading.

9.5.3 *Physical Hedging Fallback*. Where the Determination Agent determines that a Commodity Index Disruption Event has occurred and is continuing in respect of a Series on the Pricing Date in respect of such Series and "Physical Hedging Fallback" is specified as applicable in the relevant Final Terms, then the following provisions shall apply;

- (a) with respect to each Component included in the Commodity Reference Price which is not affected by the Commodity Index Disruption Event, the Relevant Price will be based on the closing prices of each such Component on the applicable determination date;
- (b) with respect to each Component included in the Commodity Reference Price which is affected by the Commodity Index Disruption Event, the Relevant Price will be based on the closing price of each such Component on the first day following the applicable determination date on which no Commodity Index Disruption Event occurs with respect to such Component;

- (c) subject to (d) below, the Determination Agent shall determine the Relevant Price by reference to the closing prices determined in (a) and (b) above using the then-current method for calculating the Relevant Price; and
- (d) where a Commodity Index Disruption Event with respect to one or more Components included in the Commodity Reference Price continues to exist (measured from and including the first day following the applicable determination date) for five consecutive Trading Days, the Determination Agent shall determine the Relevant Price in good faith and in a commercially reasonable manner. For the purposes of this paragraph (d), "**Trading Day**" shall mean a day when the exchanges for all Futures Contracts included in the relevant Commodity Reference Price are scheduled to be open for trading with respect to each Futures Contract included in the Commodity Reference Price which is not affected by the Commodity Index Disruption Event, the Relevant Price will be based on the closing prices of each such contract on the applicable determination date.

9.6 *Adjustments to Commodity Index:*

9.6.1 If a Commodity Index is permanently cancelled or is not calculated and announced by the sponsor of such Commodity Index or any of its affiliates (together the "**Sponsor**") but (i) is calculated and announced by a successor sponsor (the "**Successor Sponsor**") acceptable to the Determination Agent, or (ii) replaced by a successor index (the "**Successor Index**") using, in the determination of the Determination Agent, the same or a substantially similar formula for and method of calculation as used in the calculation of such Commodity Index, then the Commodity Reference Price will be determined by the Index so calculated and announced by that Successor Sponsor or that Successor Index, as the case may be.

9.6.2 If, for a Commodity Index with respect to a Commodity Reference Price, on or prior to the Maturity Date or Early Redemption Date, (i) the Sponsor makes a material change in the formula for or the method of calculating such Commodity Index or in any other way materially modifies such Commodity Index (other than a modification prescribed in that formula or method to maintain the Commodity Index in the event of changes in constituent commodities and weightings and other routine events), or (ii) the Sponsor permanently cancels the Commodity Index or (iii) the Sponsor fails to calculate and announce the Commodity Index for a continuous period of three Trading Days and the Determination Agent determines that there is no Successor Sponsor or Successor Index, then the Determination Agent may at its option (in the case of (i)) and shall (in the case of (ii) and (iii)) (such events (i) (ii) & (iii) to be collectively referred to as "**Index Adjustment Events**") calculate the Relevant Price using in lieu of the published level for that Commodity Index (if any), the level for that Commodity Index as at the relevant determination date as determined by the Determination Agent in accordance with the formula for and method of calculating that Commodity Index last in effect prior to the relevant Index Adjustment Event (as the case may be), but using only those Futures Contracts that comprised that Index immediately prior to the relevant Index Adjustment Event (as the case may be ) (other than those futures contracts that have ceased to be listed on any relevant exchange).

9.7 In relation to Commodity Securities, the following expressions have the meanings set out below:

"**Basket**" means a basket composed of each Commodity specified in the relevant Final Terms;

"**Commodity**" means each commodity specified in the relevant Final Terms;

"**Commodity Index**" means an index comprising commodities specified as such in the relevant Final Terms

**"Commodity Business Day"** means:

- (i) in the case where the Commodity Reference Price is a price announced or published by an Exchange, a day that is (or, but for the occurrence of a Commodity Disruption Event, would have been) a trading day on that Exchange; and
- (ii) in the case where the Commodity Reference Price is not a price announced or published by an Exchange, a day in respect of which the relevant Price Source published (or, but for the occurrence of a Commodity Disruption Event, would have published) a price;

**"Commodity Reference Price"** means the commodity reference price(s) specified in the relevant Final Terms;

**"Component"** means in respect of a Commodity Index, each commodity or Futures Contract comprising such Commodity Index;

**"Delivery Date"** means the relevant date or month for delivery of the underlying Commodity (which must be a date or month reported or capable of being determined from information reported in or by the relevant Price Source) as specified in, or determined in accordance with the provisions in, the relevant Final Terms. In relation to any underlying Commodity which is specified in the relevant Final Terms to be a "Non Metal" and each Pricing Date, the relevant Delivery Date shall be the month of expiration of the first Futures Contract to expire following such Pricing Date. In relation to any underlying Commodity which is specified in the applicable Final Terms to be a "Base Metal" or a "Precious Metal" and each Pricing Date, the Delivery Date shall be such Pricing Date;

**"DJ-AIG Commodity Index"** means the Dow Jones-AIG Commodity Index and any other Commodity Index, in each case which is calculated and sponsored by Dow Jones Inc, or any successor to such sponsor;

**"DJ-AIGCI Manual"** means the manual or handbook in respect of a DJ-AIG Commodity Index published by the sponsor of the relevant Commodity Index and in effect from time to time;

**"Exchange"** means each exchange or principal trading market specified in the relevant Final Terms, or any successor to such exchange or principal trading market;

**"Futures Contract"** means, in respect of any Commodity Security, the contract for future delivery in respect of the relevant Delivery Date relating to the relevant Commodity, or in the case of a Commodity Security relating to a Commodity Index, each of the contracts for future delivery underlying or included in the relevant Commodity Index;

**"GS Commodity Index"** means the Goldman Sachs Commodity Index and any other Commodity Index, in each case which is calculated and sponsored by Goldman, Sachs & Co., or any successor to such sponsor;

**"GSCI Manual"** means the manual or handbook in respect of a GS Commodity Index published by the sponsor of the relevant Commodity Index and in effect from time to time;

**"Price Source"** means the publication (or such other origin of reference, including an Exchange) containing (or reporting) the Specified Price (or prices from which the Specified Price is calculated) specified in the relevant Final Terms;

**"Pricing Date"** means, in respect of any Commodity Security, each date specified as such (or determined pursuant to a method specified for such purpose) for such Commodity Security;

**"Relevant Price"** on any day means in respect of a unit of measure of the Commodity to which a Commodity Security relates, the price, expressed as a price per unit, determined by the Determination Agent as provided in the relevant Final Terms with respect to the Pricing Date for the specified Commodity Reference Price; and

**"Specified Price"** means any of the following prices of a Commodity or Commodities or levels of a Commodity Index (which must be a price reported or capable of being determined from information reported in or by the relevant Price Source), as specified in the applicable Final Terms (and, if applicable, as of the time so specified) (a) the high price (b) the low price (c) the average of the high price and the low price (d) the closing price (e) the opening price (f) the bid price (g) the asked price (h) the average of the bid price and the asked price (i) the settlement price (j) the official settlement price (which shall be the Specified Price for any Commodity Index, and for any Commodity specified in the applicable Final Terms as a "Non Metal") (k) the official price (l) the morning fixing (m) the afternoon fixing (which shall be the Specified Price in respect of any Commodity specified in the applicable Final Terms as a "Precious Metal") (n) the spot price or (o) any other price specified in the applicable Final Terms. The Specified Price for any Commodity specified in the applicable Final Terms as a "Precious Metal" shall be the official cash bid price.

## 10. **PROVISIONS RELATING TO PHYSICAL SETTLEMENT SECURITIES**

This Condition 10 is applicable only in relation to Securities specified in the relevant Final Terms as being Physical Settlement Securities.

### 10.1 *Settlement Disruption:*

10.1.1 The Determination Agent shall determine, acting in a commercially reasonable manner, whether or not at any time a Settlement Disruption Event has occurred and where it determines such an event has occurred and so has prevented delivery of Underlying Securities on the original day that but for such Settlement Disruption Event would have been the Physical Settlement Date, then the Physical Settlement Date will be the first succeeding day on which delivery of such Underlying Securities can take place through the relevant Clearance System unless a Settlement Disruption Event prevents settlement on each of the 10 relevant Clearance System Business Days immediately following the original date or during such other period specified in the relevant Final Terms that, but for the Settlement Disruption Event, would have been the Physical Settlement Date. In that case, if the Underlying Securities are bonds or other debt securities, the Issuer shall use reasonable efforts to deliver such Underlying Securities promptly thereafter in a commercially reasonable manner outside the Clearance System on a delivery versus payment basis, and in all other cases: (a) if such Underlying Securities can be delivered in any other commercially reasonable manner, then the Physical Settlement Date will be the first day on which settlement of a sale of Underlying Securities executed on that 10th relevant Clearance System Business Day, or during such other period specified in the relevant Final Terms, customarily would take place using such other commercially reasonable manner of delivery (which other manner of delivery will be deemed the relevant Clearance System for the purposes of delivery of the relevant Underlying Securities), and (b) if such Underlying Securities cannot be delivered in any other commercially reasonable manner, then the Physical Settlement Date will be postponed until delivery can be effected through the relevant Clearance System or in any other commercially reasonable manner, as determined by the Determination Agent.

10.1.2 For the avoidance of doubt, where a Settlement Disruption Event affects some but not all of the Underlying Securities comprised in a Basket, the Physical Settlement Date for Underlying Securities not affected by the Settlement Disruption Event will be the first day on which settlement of a sale of such Underlying Securities executed on that Exercise Date customarily would take

place through the relevant Clearance System. In the event that a Settlement Disruption Event will result in the delivery on a Physical Settlement Date of some but not all of the Underlying Securities comprised in a Basket, the Determination Agent shall determine in its sole and absolute discretion the appropriate pro rata portion of the Strike Price (if any) to be paid by the relevant party in respect of that partial settlement.

- 10.1.3 For the purposes hereof, "**Settlement Disruption Event**" in relation to an Underlying Security means an event beyond the control of the Issuer as a result of which or following which the relevant Clearance System cannot clear the transfer of such Underlying Security.

10.2 *Delivery Disruption:*

- 10.2.1 If the Determination Agent determines, acting in a commercially reasonable manner, that a Delivery Disruption Event has occurred and the Determination Agent has notified the Issuer, the Principal Securities Agent and the relevant Securityholder(s) within one Clearance System Business Day of the relevant Exercise Date to that effect, then the Issuer may:

- (a) determine, in its sole and absolute discretion, that the obligation to deliver the relevant Underlying Securities will be terminated and the Issuer will pay an amount which the Determination Agent, in its sole and absolute discretion, determines is the fair value to the Securityholder of a Security with terms that would preserve for the Securityholder the economic equivalent of the relevant delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of such Delivery Disruption Event, less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion, in which event the entitlements of the respective exercising Securityholders to receive Underlying Securities pursuant to such exercise shall cease and the Issuer's obligations under the Securities shall be satisfied in full upon payment of such amount; or
- (b) deliver on the Physical Settlement Date such number of Underlying Securities (if any) as it can deliver on that date and pay an amount, as determined by the Determination Agent in its sole and absolute discretion, which shall seek to preserve for the Securityholder the economic equivalent of the delivery of the remainder of Underlying Securities (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of such Delivery Disruption Event, in which event the entitlements of the respective exercising Securityholders to receive Underlying Securities pursuant to such exercise shall cease and the Issuer's obligations under the Securities shall be satisfied in full upon delivery of such number of Underlying Securities and payment of such amount.

- 10.2.2 For the purposes hereof, "Delivery Disruption Event" means the failure by the Issuer or the Principal Securities Agent to deliver on the relevant Physical Settlement Date the requisite number of relevant Underlying Securities under the relevant Security which is due to illiquidity in the market for such Underlying Securities.

## 11. PROVISIONS RELATING TO ALL SECURITIES

### 11.1 *Performance Disruption:*

11.1.1 If the Determination Agent determines, acting in a commercially reasonable manner, that Performance Disruption has occurred, then the Issuer may determine, in its sole and absolute discretion, that the relevant Securities shall be terminated on the date specified in a notice to the Securityholders and the Issuer will pay an amount which the Determination Agent, in its sole and absolute discretion, determines is the fair value to the Securityholder of a Security with terms that would preserve for the Securityholder the economic equivalent of any payment or delivery (assuming satisfaction of each applicable condition precedent) to which the Securityholder would have been entitled under the relevant Security after that date but for the occurrence of such Performance Disruption, less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion, in which event the Security shall cease to be exercisable (or, in the case of any Securities which have been exercised, the entitlements of the respective exercising Securityholders to receive the relevant currency or payment of the Settlement Amount, as the case may be, pursuant to such exercise shall cease) and the Issuer's obligations under the Securities shall be satisfied in full upon payment of such amount.

11.1.2 For the purposes hereof, "**Performance Disruption**" means, in relation to any Security, the occurrence or existence on any day of any event, circumstance or cause beyond the control of the Issuer that has had or reasonably could be expected to have a material adverse effect upon (i) its ability to perform its obligations under, or hedge its positions with respect to, the relevant Security; (ii) the ability of any hedging counterparty of the Issuer to perform its obligations under any hedging transaction entered into by the Issuer to hedge all or any of its liabilities in respect of the Securities or any of them; or (iii) the availability of hedging transactions in the market.

### 11.2 *Effects of European Economic and Monetary Union:*

11.2.1 Following the occurrence of an EMU Event, the Determination Agent may make such adjustment (and determine the effective date of such adjustment) as it, in its sole and absolute discretion, determines appropriate, if any, to the Strike Price (if any), the formula for the Cash Settlement Amount, the Settlement Price, the Settlement Rate, the Relevant Price, the Spot Rate, the number of Underlying Securities to which each Security relates, the number of Underlying Securities comprised in a Basket, the amount, the number of or type of shares, bonds, other securities or other property which may be delivered in respect of such Securities and/or any other adjustment and, in any case, any other variable relevant to the exercise, settlement, payment or other terms of the relevant Securities which in the sole and absolute discretion of the Determination Agent have been or may be affected by such EMU Event.

11.2.2 Following the occurrence of an EMU Event, without prejudice to the generality of the foregoing, the Issuer shall be entitled to: (i) make such conversions between amounts denominated in the national currency units (the "National Currency Units") of the member states of the European Union that have adopted the single currency in accordance with the EC Treaty and the euro, and the euro and the National Currency Units, in each case, in accordance with the conversion rates and rounding rules established by the Council of the European Union pursuant to the EC Treaty as it, in its sole and absolute discretion, considers appropriate; (ii) make all payments in respect of the Securities solely in euro as though references in the Securities to the relevant National Currency Units were to euro and (iii) make such adjustments as it, in its sole and absolute discretion considers necessary to the Strike Price (if any), the formula for the Cash Settlement Amount,

Settlement Rate, Settlement Price, Relevant Price, Spot Rate and any other amount as it determines, in its sole and absolute discretion, to be appropriate.

- 11.2.3 None of the Issuer, the Principal Securities Agent or the Determination Agent will be liable to any Securityholder or other person for any commissions, costs, losses or expenses in relation to or resulting from any currency conversion or rounding effected in connection therewith.
- 11.2.4 For the purposes hereof, "**EMU Event**" means the occurrence of any of the following, as determined by the Determination Agent, acting in a commercially reasonable manner:
- (a) the withdrawal from legal tender of any currency that, before the introduction of the euro, was lawful currency in one of the member states;
  - (b) the redenomination of any Underlying Security into euro;
  - (c) any change in the currency of denomination of any Index;
  - (d) any change in the currency in which some or all the securities or other property contained in any Index is denominated;
  - (e) the disappearance or replacement of a relevant rate option or other price source for the national currency of any member state, or the failure of the agreed sponsor (or successor sponsor) to publish or display a relevant rate, index, price, page or screen; or
  - (f) the change by any organised market, exchange or clearance, payment or settlement system in the unit of account of its operating procedures to the euro.

## 12. **SECURITIES AGENTS AND DETERMINATION AGENT**

12.1 *Appointment of Agents:* The Issuer reserves the right at any time to vary or terminate the appointment of any Securities Agent or the Determination Agent and to appoint substitute or additional Securities Agents or a substitute or additional Determination Agent, provided that (i) so long as any Security is outstanding, it will maintain a Principal Securities Agent and (ii) so long as the Securities are admitted to listing, trading and/or quotation by any listing authority, stock exchange and/or quotation system, there will be a Securities Agent with a specified office in such place as may be required by the rules of such listing agent, stock exchange and/or quotation system. Notice of any termination of appointment and of any change in the specified office of a Securities Agent or a Determination Agent and of any appointment of a Securities Agent or a Determination Agent will be given to Securityholders in accordance with Condition 15 (*Notices*).

### 12.2 *Role of Agents:*

- 12.2.1 In acting under the Securities Agreement, each Securities Agent and each Determination Agent acts solely as agent of the Issuer and does not assume any obligation or duty to, or any relationship of agency or trust for or with, the Securityholders. All calculation and determination functions required of the Determination Agent or the Principal Securities Agent under these Conditions may be delegated to any such person as the Determination Agent or the Principal Securities Agent, as the case may be, in its absolute discretion, may decide.
- 12.2.2 None of the Issuer, the Guarantor (if applicable), the Principal Securities Agent or the Determination Agent shall have any responsibility for any errors or omissions in the calculation and dissemination of any variables used in any calculation made pursuant to these Conditions or in the determination of any Cash Settlement Amount or of any entitlement to a delivery of any Underlying Securities arising from such errors or omissions.

12.3 *Notifications:* All notifications, opinions, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the Securities by the Principal Securities Agent, the Determination Agent or the Issuer shall (in the absence of manifest error or wilful misconduct) be binding on the Issuer and the Securityholders and (subject as aforesaid) no liability to the Securityholders (or any of them) shall attach to the Principal Securities Agent, the Determination Agent or the Issuer in connection with the exercise or non-exercise by any of them of their powers, duties and discretions for such purposes.

### 13. **TAXES**

13.1.1 A Securityholder subscribing, purchasing or exercising a Security shall pay all Taxes and securities transfer taxes and any other charges, if any payable in connection with the subscription, issue, purchase or exercise of such Security and the payment of the Cash Settlement Amount and/or the delivery of any Underlying Securities as a result of such exercise. The Issuer shall have the right, but not the duty, to withhold or deduct from any amounts otherwise payable to a Securityholder such amount as is necessary for the payment of any such taxes, duties or charges or for effecting reimbursement in accordance with Condition 13.1.2 below.

13.1.2 In any case where the Issuer is obliged to pay any such tax, duty or charge referred to in Condition 13.1.1 above, the relevant Securityholder shall promptly reimburse the Issuer therefor.

13.1.3 The Issuer shall not be liable for or otherwise be obliged to pay any tax, duty, withholding or other payment which may arise as a result of the ownership, issue, transfer or exercise of any Securities.

### 14. **FORCE MAJEURE AND ILLEGALITY**

14.1 The Issuer shall have the right to terminate the Securities if it shall have determined, in its sole and absolute discretion, that its performance thereunder shall have become or will be unlawful in whole or in part as a result of compliance in good faith by the Issuer with any applicable present or future law, rule, regulation, judgment, order or directive of any governmental, administrative, legislative or judicial authority or power ("applicable law").

14.2 In such circumstances the Issuer will, however, if and to the extent permitted by applicable law, pay to each Securityholder in respect of each Security held by him an amount determined by the Determination Agent, in its sole and absolute discretion, as representing the fair market value of such Security immediately prior to such termination (ignoring such illegality) less the cost to the Issuer of, or the loss realised by the Issuer on, unwinding any related underlying hedging arrangements, the amount of such cost or loss being as determined by the Determination Agent in its sole and absolute discretion. Payment will be made to the relevant Clearance System in such manner as shall be notified to the Securityholders in accordance with Condition 15 (Notices).

### 15. **NOTICES**

15.1 All notices to the Securityholders, save where another means of communication has been specified in the relevant Final Terms, will be deemed to have been duly given if:

15.1.1 as long as the relevant Clearance System has procedures for transmitting copies, or the contents of notices to Securityholders to its account holders, notified to such relevant Clearance System; and

15.1.2 in the case of Securities admitted to the official list of the Irish Stock Exchange and to trading on the Irish Stock Exchange (or admitted to listing, trading and/or quotation by any other listing authority, stock exchange and/or quotation system), published in one daily newspaper of general circulation in Europe and the Republic of Ireland (which is expected to be the Irish Times) (or

such other publication required by the rules of such other listing authority, stock exchange and/or quotation system).

- 15.2 If publication in such a newspaper is not practicable, notice will be given in such other manner as the Principal Securities Agent on behalf of the Issuer shall determine in its sole and absolute discretion. Such notices shall be deemed to have been given on the date of such publication or, if published more than once or on different dates, on the first date on which publication shall have been made in the newspaper in which publication is required.

16. **LOSSES**

In no event shall the Issuer have any liability for indirect, incidental, consequential or other damages (whether or not it may have been advised of the possibility of such damages) other than interest until the date of payment on sums not paid when due in respect of any Securities or assets not delivered when due. Securityholders are entitled to damages only and are not entitled to the remedy of specific performance in respect of a Security.

17. **SEVERANCE AND MODIFICATION OF CONDITIONS**

- 17.1 Should any of the provisions contained in these Conditions be or become invalid, the validity of the remaining provisions shall not be affected in any way.

- 17.2 The Issuer may modify the Conditions without the consent of the Securityholders for the purposes of curing any ambiguity or correcting or supplementing any provision contained herein in any manner which the Issuer may deem necessary or desirable provided that such modification is not materially prejudicial to the interests of the Securityholders. Notice of any such modification will be given to the Securityholders in accordance with Condition 15 (*Notices*) but failure to give, or non-receipt of, such notice will not affect the validity of such modification.

18. **FURTHER ISSUES**

The Issuer is at liberty from time to time without the consent of the Securityholders to create and issue further Securities of any particular Series so as to form a single series with the Securities of such Series, but upon such terms as to issue price and otherwise as the Issuer may determine in its sole and absolute discretion.

19. **PURCHASE OF SECURITIES BY ISSUER OR AFFILIATE**

The Issuer or an Affiliate may at any time and from time to time purchase Securities at any price in the open market or otherwise. Such Securities may, at the option of the Issuer or, as the case may be, the relevant Affiliate, be held, resold, reissued or cancelled or otherwise dealt with. No Security which has been exercised, or purchased and cancelled, may be re-issued.

20. **SUBSTITUTION**

The Issuer shall be entitled at any time and from time to time, without the consent of the Securityholders, to substitute any other member of the group comprising Morgan Stanley and any Affiliates (the "**New Issuer**") in its place as obligor under the Securities, provided that the New Issuer shall assume all obligations of the Issuer in relation to the Securityholders under or in relation to the Securities. In the event of such substitution, any reference in these Conditions to the Issuer shall be construed as a reference to the New Issuer. Such substitution shall be promptly notified to the Securityholders in accordance with Condition 15 (*Notices*). In connection with such right of substitution, the Issuer shall not be obliged to have regard to the consequences of the exercise of such right for individual Securityholders in particular, without limitation,

any consequences resulting from their being for any purpose domiciled or resident in, or otherwise connected with, or subject to the jurisdiction of, any particular territory, and no Securityholder shall be entitled to claim from the Issuer any indemnification or payment in respect of any tax or other consequence of any such substitution upon such Securityholder.

## 21. **RIGHTS OF THIRD PARTIES**

No person shall have any right to enforce any term or condition of the Securities under the Contracts (Rights of Third Parties) Act 1999.

## 22. **REPRESENTATIONS AND ACKNOWLEDGEMENTS BY SECURITYHOLDERS**

Each Securityholder shall be deemed to represent and acknowledge to the Issuer on acquiring any Securities that:

- (a) neither the Issuer nor any Affiliate or any of their agents is acting as a fiduciary for it or provides investment, tax, accounting, legal or other advice in respect of the Securities and that such Securityholder and its advisors are not relying on any communication (written or oral and including, without limitation, opinions of third party advisors) of the Issuer or any Affiliate as (i) legal, regulatory, tax, business, investment, financial, accounting or other advice, (ii) a recommendation to invest in any Securities or (iii) an assurance or guarantee as to the expected results of an investment in the Securities (it being understood that information and explanations related to the terms and conditions of the Securities shall not be considered to be any such advice, recommendation, assurance or guarantee and should be independently confirmed by the recipient and its advisors prior to making any such investment);
- (b) such Securityholder (i) has consulted with its own legal, regulatory, tax, business, investments, financial and accounting advisors to the extent that it has deemed necessary, and has made its own investment, hedging, and trading decisions based upon its own judgment and upon any advice from such advisors as it has deemed necessary and not upon any view expressed by the Issuer or any Affiliate or any of their agents and (ii) is acquiring Securities with a full understanding of the terms, conditions and risks thereof and it is capable of and willing to assume those risks; and
- (c) the Issuer and/or any Affiliates may have banking or other commercial relationships with issuers of any securities to which the Securities relate and may engage in proprietary trading in any securities, indices, commodities or other property to which the Securities relate or options, futures, derivatives or other instruments relating thereto (including such trading as the Issuer and/or any Affiliate deem appropriate in their sole discretion to hedge the market risk on the Securities and other transactions between the Issuer and/or any Affiliates and any third parties), and that such trading (i) may affect the price or level thereof and consequently the amounts payable under the Securities and (ii) may be effected at any time, including on or near any Valuation or Averaging Date.

## 23. **GOVERNING LAW AND PROCEEDINGS**

23.1 The Securities shall be governed by, and construed in accordance with, English law.

23.2 The Issuer agrees for the benefit of each Securityholder that the courts of England shall have jurisdiction to hear and determine any suit, action or proceedings, and to settle any disputes, which may arise out of or in connection with the Securities (respectively, "Proceedings" and "Disputes") and, for such purpose, irrevocably submits to the jurisdiction of such courts.

- 23.3 The Issuer irrevocably waives any objection which it might now or hereafter have to the courts of England being nominated as the forum to hear and determine any Proceedings and to settle any Disputes, and agrees not to claim that any such court is not a convenient or appropriate forum.
- 23.4 The Issuer agrees that process in connection with Proceedings in the courts of England will be validly served on it if served upon Morgan Stanley & Co. International Limited, 25 Cabot Square, Canary Wharf, London E14 4QW or, if different, its registered office for the time being or at any address of the Issuer in the Great Britain at which process may be served on it in accordance with Part XXIII of the Companies Act 1985. If such person is not or ceases to be effectively appointed to accept service of process on the Issuer's behalf, the Issuer shall, on the written demand of any Securityholder addressed to the Issuer and delivered to the Issuer or to the Specified Office of the Principal Securities Agent, appoint a further person in England to accept service of process on its behalf and, failing such appointment within 15 days, any Securityholder shall be entitled to appoint such a person by written notice addressed to the Issuer and delivered to the Issuer or to the Specified Office of the Principal Securities Agent. Nothing in this Condition shall affect the right of any Securityholder to serve process in any other manner permitted by law.
- 23.5 The submission to the jurisdiction of the courts of England shall not (and shall not be construed so as to) limit the right of any Securityholder to take Proceedings in any other court of competent jurisdiction, nor shall the taking of Proceedings in any one or more jurisdictions preclude the taking of Proceedings in any other jurisdiction (whether concurrently or not) if and to the extent permitted by law.

## ERISA

The Securities may not be acquired or held by, or acquired with the assets of, any employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"), or any individual retirement account or plan subject to Section 4975 of the United States Internal Revenue Code of 1986, as amended (the "**Code**").

### **Legend Concerning United States Persons**

Unless otherwise specified in the Final Terms, in the case of Securities (or any Tranche thereof) having a maturity of more than 183 days, the Global Warrants and the definitive Securities will bear a legend to the following effect:

"Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in Sections 165(j) and 1287(a) of the Internal Revenue Code."

The sections referred to in such legend provide that a United States person who holds a Security will generally not be allowed to deduct any loss realized on the sale, exchange or redemption of such Security and any gain (which might otherwise be characterized as capital gain) recognized on such sale, exchange or redemption will be treated as ordinary income.

Unless otherwise specified in the Final Terms, any Securities (or any Tranche thereof) having a maturity of 183 days or less must have a minimum face and principal amount of \$500,000 and bear the following legend:

"By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in Section 6049(b)(4) of the Internal Revenue Code and regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in Section 6049(b)(4) of the Internal Revenue Code and regulations thereunder)."

### **Limitations on Issuance of Bearer Securities**

Unless otherwise specified in the Final Terms, bearer Securities, including bearer Securities in global form, will not be offered, sold or delivered, directly or indirectly, in the United States or its possessions or to United States persons, as defined below, except as otherwise permitted by United States Treasury Regulations Section 1.163 5(c)(2)(i)(D). Any underwriters, agents or dealers participating in the offerings of bearer Securities, directly or indirectly, must agree that (i) they will not, in connection with the original issuance of any bearer Securities or during the restricted period with respect to such bearer Securities (as defined in United States Treasury Regulations Section 1.163 5(c)(2)(i)(D)(7)) (the "**Restricted Period**"), offer, sell or deliver, directly or indirectly, any bearer Securities in the United States or its possessions or to United States persons, other than as permitted by the applicable Treasury Regulations described above; and (ii) they will not at any time offer, sell or deliver, directly or indirectly, any bearer Securities in the United States or its possessions or to United States persons, other than as permitted by the applicable Treasury Regulations above. For these purposes, it is presumed that United States Treasury Regulations Section 1.163 5(c)(2)(i)(D) will apply to the bearer Securities.

In addition, any underwriter, agent or dealer must have procedures reasonably designed to ensure that its employees or agents who are directly engaged in selling bearer Securities are aware of the above restrictions on the offering, sale or delivery of bearer Securities.

Unless otherwise specified in the Final Terms, bearer Securities, other than bearer Securities that satisfy the requirements of United States Treasury Regulations Section 1.163 5(c)(2)(i)(D)(3)(iii), will not be delivered in definitive form, and no payment will be made thereon, unless the relevant Issuer has received a signed certificate in writing, or an electronic certificate described in United States Treasury Regulations Section 1.163

5(c)(2)(i)(D)(3)(ii), (an "**Ownership Certificate**") stating that on the date of the Ownership Certificate that bearer Security:

- (1) is owned by a person that is not a United States person;
- (2) is owned by a United States person that is described in United States Treasury Regulations Section 1.163-5(c)(2)(i)(D)(6); or
- (3) is owned by a United States or foreign financial institution for the purposes of resale during the Restricted Period,

and, in addition, if the owner of the bearer Security is a United States or foreign financial institution described in clause (3) above, whether or not also described in clause (1) or clause (2) above, the financial institution certifies that it has not acquired the bearer Security for purposes of resale directly or indirectly to a United States person or to a person within the United States or its possessions.

The relevant Issuer will make payments on bearer Securities only outside the United States and its possessions except as permitted by the above regulations.

As used herein, "**United States person**" means, for United States federal income tax purposes, (i) a citizen or resident of the United States; (ii) a corporation, partnership or other entity created or organized in or under the laws of the United States or any political subdivision thereof; or (iii) an estate or trust the income of which is subject to United States federal income taxation regardless of its source.

## UNITED STATES TAXATION

**This discussion is limited to the Federal tax issues addressed below. Additional issues may exist that are not addressed in this discussion and that could affect the Federal tax treatment of the transaction. Because this tax disclosure was written in connection with the marketing of the Program for the Issuance of Warrants and Certificates, it cannot be used by any holder for the purpose of avoiding penalties that may be asserted against the holder. Holders should seek their advice based on their particular circumstances from an independent tax advisor.**

*References to "Securities" herein refer only to Securities issued by Morgan Stanley, Morgan Stanley Jersey or MSBV, not to Securities issued by an Additional Issuer.*

The Issuers have been advised that the following summary accurately describes the principal United States federal income and estate tax consequences of ownership and disposition of the Securities by Non-U.S. Holders (as defined below). This summary is based on the Code, administrative pronouncements, judicial decisions and existing and proposed Treasury regulations, changes to any of which subsequent to the date of this Base Prospectus may affect the tax consequences described herein.

This summary does not discuss all of the tax consequences that may be relevant to holders in light of their particular circumstances or to holders subject to special rules, such as:

- persons other than Non-U.S. Holders;
- nonresident alien individuals who have lost their United States citizenship or who have ceased to be treated as resident aliens; or
- corporations that are treated as personal holding companies, controlled foreign corporations, or passive foreign investment companies.

Persons considering the purchase of Securities should consult their own tax advisors with regard to the application of the United States federal tax laws to their particular situations, as well as any tax consequences arising under the laws of any state, local or foreign taxing jurisdiction.

As used herein, the term "Non-U.S. Holder" means a beneficial owner of a Security that is for United States federal income tax purposes:

- a nonresident alien individual;
- a foreign corporation;
- a nonresident alien fiduciary of a foreign estate or trust; or
- a foreign partnership one or more of the members of which is a nonresident alien individual, a foreign corporation or a nonresident alien fiduciary of a foreign trust or estate.

### **General**

Except as otherwise indicated in the applicable Final Terms, a Non-U.S. Holder will generally not be subject to United States federal income tax, including withholding tax, on payments on a Security, or on proceeds from the sale or other disposition of a Security, provided that for purposes of United States federal income tax law:

- the payments or proceeds are not effectively connected with the conduct of a trade or business within the United States by the holder;
- the holder does not own (directly or by attribution) ten percent or more of the total combined voting power of all classes of stock of Morgan Stanley entitled to vote;
- the holder is not a bank holding the Security in the context of an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business; and
- the holder does not have a "tax home" (as defined in section 911(d)(3) of the Code) or an office or other fixed place of business in the United States.

### **Backup Withholding and Information Reporting**

In general, U.S. information reporting and backup withholding will not apply to payments on Securities held by a Non-U.S. Holder and received outside the United States through a non-U.S. bank or other non-U.S. financial institution. Proceeds on sales and payments on Securities received within the United States or through certain U.S.-related financial institutions may be subject to information reporting and backup withholding unless the Non-U.S. holder complies with applicable certification procedures to establish that it is not a U.S. person.

### **Estate Tax**

Non-U.S. Holders who are individuals, and holders that are entities the property of which is potentially includible in such an individual's gross estate for U.S. federal estate tax purposes (for example, a trust funded by such an individual and with respect to which the individual has retained certain interests or powers), should note that, absent an applicable treaty benefit, a Security may be treated as U.S. situs property subject to U.S. federal estate tax. Such individuals and entities should consult their own tax advisors regarding the U.S. federal estate tax consequences of investing in the Securities.

## UNITED KINGDOM TAXATION

*The following disclosure applies only in respect of Securities issued by Morgan Stanley, Morgan Stanley Jersey or MSBV and not in respect of Securities issued by an Additional Issuer or any substitute issuer. References in this section on United Kingdom taxation to "Securities" refer only to Securities issued by Morgan Stanley, Morgan Stanley Jersey or MSBV, and references to Securityholders should be construed accordingly. The following assumes that Morgan Stanley, Morgan Stanley Jersey and MSBV are not resident in the United Kingdom for United Kingdom tax purposes and are not issuing the Securities for the purposes of a trade or other business carried on by them in the United Kingdom and that any payment on the Securities does not have a United Kingdom source.*

Transactions involving Securities, including the issue of any Global Warrant, any purchase or disposal or abandonment of or other dealings in the Securities and any transaction involved in the exercise and settlement of Securities, may have United Kingdom tax consequences for potential purchasers (including but not limited to possible liabilities to stamp duties, transfer and registration taxes). The United Kingdom tax consequences may depend, amongst other things, upon the status of the potential purchaser and the terms and conditions of a particular Security. Potential purchasers should consult their own tax advisors about the United Kingdom tax implications of purchasing and holding a Security, any transaction involving a Security and any transaction involved in the exercise and settlement of a Security.

## JERSEY TAXATION

Prospective purchasers of Securities issued by Morgan Stanley Jersey should consult their tax advisors as to the consequences under the tax laws of the country of which they are resident for tax purposes and the tax laws of Jersey/United States of America of acquiring, holding and disposing of such securities and receiving payments of interest, principal and/or other amounts under such securities.

The following summary is based on the laws and practices currently in force in Jersey at the date of this document and is subject to changes therein.

Holders of Securities issued by Morgan Stanley Jersey (other than residents of Jersey) are not subject to any tax in Jersey in respect of the holding, sale or other disposition of such securities. So long as the Issuer maintains its "exempt company" status, interest on such securities may be paid by Morgan Stanley Jersey without withholding or deduction for or on account of Jersey income tax.

No stamp duties are payable in Jersey on the acquisition, ownership, redemption, sale or other disposal of such securities. Stamp duty is payable in Jersey on the registration of Probate or Letters of Administration relating to the death of an individual holder of such securities with assets situate in Jersey, which is calculated by reference to the value of the holder's estate in Jersey.

As part of an agreement reached in connection with the European Union (the "EU") directive on the taxation of savings income in the form of interest payments, and in line with steps taken by other relevant third countries, Jersey introduced with effect from 1 July 2005 a retention tax system in respect of payments of interest, or other similar income, made to an individual beneficial owner resident in an EU Member State by a paying agent established in Jersey. The retention tax system applies for a transitional period prior to the implementation of a system of automatic communication to EU Member States of information regarding such payments. During this transitional period, such an individual beneficial owner resident in an EU Member State will be entitled to request a paying agent not to retain tax from such payments but instead to apply a system by which the details of such payments are communicated to the tax authorities of the EU Member State in which the beneficial owner is resident.

The retention tax system in Jersey is implemented by means of bilateral agreements with each of the EU Member States, the Taxation (Agreements with European Union Member States) (Jersey) Regulations 2005 and Guidance Notes issued by the Policy & Resources Committee of the States of Jersey. Based on these provisions and what is

understood to be the current practice of the Jersey tax authorities, Morgan Stanley Jersey would not be obliged to levy retention tax in Jersey under these provisions in respect of interest payments made by it to a paying agent established outside Jersey.

### **European Union Code of Conduct on Business Taxation**

On 3 June 2003, the European Union Council of Economic and Finance Ministers reached political agreement on the adoption of a Code of Conduct on Business Taxation. Jersey is not a member of the EU, however, the Policy & Resources Committee of the States of Jersey has announced that, in keeping with Jersey's policy of constructive international engagement, it intends to propose legislation to replace the Jersey exempt company regime by the end of 2008 with a general zero rate of corporate tax.

It is intended that the new corporate tax will preserve tax neutrality (and so retain the existing benefits of the exempt company regime through a revised fiscal structure). Unlike the exempt company regime, it is anticipated that the new regime will not require an annual application/election or the payment of any sum by the relevant company.

## NETHERLANDS TAXATION

*The following disclosure applies only in respect of Securities issued by MSBV and not in respect of Securities issued by Morgan Stanley, Morgan Stanley Jersey or an Additional Issuer or any substitute issuer. References in this section on Netherlands taxation to "Securities" refer only to Securities issued by MSBV and references to holders of Securities should be construed accordingly.*

The following summary outlines certain Netherlands tax consequences to holders of Securities. It is based on the current law and practice of the Netherlands, which is subject to changes that could prospectively or retrospectively affect the stated tax consequences. Prospective holders of Securities who may be in any doubt as to their respective tax positions should consult their own professional advisors.

### **Withholding Tax**

All payments under Securities may be made free of withholding or deduction of, for or on account of any taxes of whatever nature imposed, levied, withheld or assessed by the Netherlands or any political subdivision or taxing authority thereof or therein, provided that, with respect to Securities, (i) they have a fixed maturity of not more than 10 years or (ii) if they have no fixed maturity or a fixed maturity of more than 10 years, the interest on such Securities is not legally or *de facto* in whole or in part contingent on the profits of, or the distributions of profits by, MSBV, Morgan Stanley or any related entity or (iii) if they are subordinated and have no fixed maturity or a fixed maturity of more than 50 years, the payment of the interest is not contingent on the profit of, or distribution of profit by, MSBV, Morgan Stanley or any related entity.

### **Taxes on Income and Capital Gains**

A holder of Securities will not be subject to any Netherlands taxes on income or capital gains in respect of Securities, including such tax on any payment under Securities or in respect of any gain realised on the disposal, deemed disposal or exchange of Securities, provided that:

- (i) such holder is neither a resident nor deemed to be a resident of the Netherlands, nor, if he is an individual, has elected to be taxed as a resident of the Netherlands;
- (ii) such holder does not have an enterprise or an interest in an enterprise that is, in whole or in part, carried on through a permanent establishment or a permanent representative in the Netherlands and to which enterprise or part of an enterprise, as the case may be, Securities are attributable;
- (iii) if such holder is an individual, neither such holder nor any of his spouse, his partner, a person deemed to be his partner, or other persons sharing such person's house or household, or certain other of such persons' relatives (including foster children), (a) has indirectly the disposition of the proceeds of Securities, nor (b) has a substantial interest in MSBV, Morgan Stanley and/or any other entity that legally or *de facto*, directly or indirectly, has the disposition of the proceeds of Securities. For purposes of this clause (iii), a substantial interest is generally not present if a holder does not hold, alone or together with his spouse or partner, whether directly or indirectly, the ownership of, or certain other rights (including rights to acquire shares, whether or not already issued) over, (a) shares representing five per cent. or more of the total issued and outstanding capital (or of the issued and outstanding capital of any class of shares) of a company, (b) profit sharing certificates, or membership rights in a co-operative association, entitling the holder to five per cent. or more of the profits or of the liquidation distributions of a company or co-operative association, or (c) membership rights representing five per cent. or more of the voting rights in a co-operative association's general meeting;
- (iv) if such holder is a company, such holder does not have a substantial interest in MSBV or if such holder does have such a substantial interest, it can be allocated to the holder's business assets. For purpose of this clause

(iv), a substantial interest is generally not present if a holder does not hold, whether directly or indirectly, the ownership of, or certain other rights (including the rights to acquire shares, whether or not already issued) over shares representing five per cent. or more of the total issued and outstanding capital (or of the issued and outstanding capital of any class of shares) of the Issuer, or (b) profit sharing certificates, entitling the holder to five per cent. or more of the profits or of the liquidation distributions of the Issuer; and

- (v) if such holder is an individual, such income or capital gain do not form "benefits from miscellaneous activities in the Netherlands" ("resultaat uit overige werkzaamheden in Nederland"), which would for instance be the case if the activities in the Netherlands with respect to Securities exceed "normal active asset management" ("normaal, actief vermogensbeheer").

A holder of Securities will not be subject to taxation in the Netherlands by reason only of the execution, delivery and/or enforcement of the documents relating to an issue of Securities or the performance by MSBV of its obligations thereunder or under Securities.

### **Gift, Estate and Inheritance Taxes**

No gift, estate or inheritance taxes will arise in the Netherlands with respect to an acquisition of Securities by way of a gift by, or on the death of, a holder of Securities who is neither resident nor deemed to be resident in the Netherlands, unless:

- (i) such holder at the time of the gift has or at the time of his death had an enterprise or an interest in an enterprise that is or was, in whole or in part, carried on through a permanent establishment or a permanent representative in the Netherlands and to which enterprise or part of an enterprise, as the case may be, Securities are or were attributable; or
- (ii) in the case of a gift of Securities by an individual who at the date of the gift was neither resident nor deemed to be resident in the Netherlands, such individual dies within 180 days after the date of the gift, while being resident or deemed to be resident in the Netherlands.

### **Turnover Tax**

No Netherlands turnover tax will arise in respect of any payment in consideration for the issue of Securities, with respect to any cash settlements of Securities or with respect to the delivery of securities under Securities.

### **Other Taxes and Duties**

No Netherlands capital tax, registration tax, custom duty, transfer tax, stamp duty or any other similar documentary tax or duty, other than court fees, will be payable in the Netherlands in respect of or in connection with the execution, delivery and/or enforcement by legal proceedings (including the enforcement of any foreign judgment in the Courts of the Netherlands) of the documents relating to the issue of Securities or the performance by MSBV of its obligations thereunder or under Securities.

## **IRISH TAXATION**

*The following disclosure relates only to withholding taxes arising under current Irish law and practice operated by the Irish Revenue Commissioners.*

Save as outlined below, payments under the Securities may be made free of withholding or deduction of, for or on account of any taxes withheld by Ireland or any political subdivision or taxing authority thereof or therein.

Securityholders should note that where any interest on Securities is paid to them ( or to any person acting on their behalf) by any paying agent in Ireland, or is received by a collecting agent acting in Ireland on behalf of a Securityholder, then the paying agent or collecting agent, may, in certain cases be required to supply the Irish Revenue Commissioners with details of the payment and certain details relating to the Securityholder (including the Securityholder's name and address). This applies whether or not the payments have been made subject to a withholding and irrespective of whether the Securityholder is resident for tax purposes in Ireland.

Securityholders should also note that where any interest on Securities is paid to them (or to any person acting on their behalf) by any paying agent in Ireland, or is received by a collecting agent acting in Ireland on behalf of a Securityholder, then the paying agent or collecting agent, may be required to deduct tax at the standard rate of income tax, which is currently 20%. This obligation does not arise in the case of Securities which are quoted eurobonds within the meaning of Section 64 of the Irish Taxes Consolidation Act, 1997 where the person who is the beneficial owner of the Security and entitled to the interest is (i) not resident in Ireland; (ii) has made a declaration in the prescribed form; (iii) and has provided that declaration to the collection or encashment agent; (iv) and the interest is not deemed under the provisions of Irish tax legislation to be that of some other person. Securityholders should be aware that the appointment of an Irish collection or encashment agent may otherwise bring them within the charge to Irish encashment tax.

## EUROPEAN UNION SAVINGS DIRECTIVE

On 3 June 2003, the EU Council of Economic and Finance Ministers adopted a new directive regarding the taxation of savings income (the "**EU Savings Tax Directive**") which applies from 1 July 2005. Under the EU Savings Tax Directive, each Member State is required to provide to the tax authorities of another Member State details of payments of interest or other similar income paid by a person within its jurisdiction to, or collected by such a person for, an individual resident in that other Member State; however, Austria, Belgium and Luxembourg will, unless they elect otherwise, instead apply a withholding system for a transitional period in relation to such payments, deducting tax at rates rising over time to 35%. The transitional period is to terminate at the end of the first full fiscal year following agreement by certain non-EU countries to the exchange of information relating to such payments.

A number of non-EU countries, and certain dependent or associated territories of certain Member States, have agreed to adopt similar measures (either provision of information or transitional withholding) in relation to payments made by a person within its jurisdiction, to, or collected by such a person for, an individual resident in a Member State. In addition, the Member States have entered into reciprocal provisions of information or transitional withholding arrangements with certain of these dependent or associated territories in relation to payments made by a person in a Member State to, or collected by such person for, an individual resident in one of these territories.

## SUBSCRIPTION AND SALE

Each Issuer is offering the Securities on a continuing basis through Morgan Stanley & Co. International Limited and Morgan Stanley & Co. Incorporated (the "**Distribution Agents**"), who have agreed to use reasonable efforts to solicit offers to purchase the Securities. Each Issuer will have the sole right to accept offers to purchase Securities and may reject any offer in whole or in part. The Distribution Agents will have the right to reject any offer to purchase Securities solicited by it in whole or in part. Each Issuer may pay the Distribution Agents, in connection with sales of the Securities resulting from a solicitation the Distribution Agents made or an offer to purchase received by the Distribution Agents, a commission, which may be in the form of a discount from the purchase price if the Distribution Agents are purchasing the Securities for their own account. Payment of the purchase price of the Securities will be required to be made in immediately available funds.

Each Issuer may also sell Securities to a Distribution Agent as principal for its own account at a price to be agreed upon at the time of sale. The Distribution Agents may resell any Securities they purchase as principal at prevailing market prices, or at other prices, as the Distribution Agents determine.

The arrangements for the offer and sale of the Securities from time to time are set out in the Regulation S Euro Distribution Agreement as modified and restated on 11 July 2006 (as further modified and restated from time to time, the "**Distribution Agreement**") among Morgan Stanley, Morgan Stanley Jersey, MSBV and the Distribution Agents (and any Additional Issuer that accedes to the Program). Pursuant to the Distribution Agreement, Morgan Stanley, Morgan Stanley Jersey, MSBV and the Distribution Agents have agreed (and any Additional Issuer that accedes to the Program shall agree) to indemnify each other against certain liabilities, or to contribute payments made in respect thereof. Morgan Stanley, Morgan Stanley Jersey and MSBV have also agreed (and any Additional Issuer that accedes to the Program shall agree) to reimburse the Distribution Agents for certain expenses.

### **United States of America**

The Securities have not been and will not be registered under the Securities Act and may not be offered, sold or delivered, *at any time*, within the United States or to, or for the account or benefit of, U.S. Persons. Each Distribution Agent (1) has acknowledged that the Securities have not been and will not be registered under the Securities Act, or any securities laws of any state in the United States, are subject to U.S. tax law requirements, and the Securities are not being offered or sold and may not be offered, sold or delivered at any time, directly or indirectly, within the United States or to or for the account or benefit of U.S. Persons (as defined either in Regulation S under the Securities Act or the Code); (2) has represented, as a condition to acquiring any interest in the Securities, that neither it nor any persons for whose account or benefit the Securities are being acquired is a U.S. Person, is located in the United States, or was solicited to purchase Securities while present in the United States; (3) has agreed not to offer, sell or deliver any of the Securities, directly or indirectly, in the United States to any U.S. Person; (4) has agreed that, at or prior to confirmation of sale of any Securities (whether upon original issuance or in any secondary transaction), it will have sent to each distributor, dealer or person receiving a selling concession, fee or other remuneration that purchases Securities from it a written notice containing language substantially the same as the foregoing. As used herein, "**United States**" means the United States of America (including the states and the District of Columbia), its territories and possessions.

In addition, the Distribution Agents have represented and agreed that they have not offered or sold Securities and will not offer or sell Securities *at any time* except in accordance with Rule 903 of Regulation S under the Securities Act. Accordingly, the Distribution Agents have represented and agreed that neither they, their affiliates (if any) nor any person acting on its or their behalf has engaged or will engage in any directed selling efforts with respect to Securities, and it and they have complied and will comply with the offering restrictions requirements of Regulation S. Terms used in this paragraph have the meanings given to them by Regulation S.

The Securities are also subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a U.S. Person. The Securities will be issued in accordance with the provisions of United States Treasury Regulation § 1.163-5(c)(2)(i)(D). Terms used in this paragraph have the meanings given to them by the Code.

### **European Economic Area**

Each Distribution Agent has represented, warranted and agreed that it has not offered and will not offer any Securities to persons in any Member State of the European Economic Area, except that it may offer Securities in any Member State:

- (a) in the period beginning on the date of publication of a prospectus in relation to those Securities which has been approved by the competent authority in a Member State in accordance with the Prospectus Directive and, where appropriate, notified to the competent authority in the Member State in which such offer is being made in accordance with Article 18 of the Prospectus Directive and ending on the date which is 12 months after the date of such publication;
- (b) at any time to legal entities which are authorised or regulated to operate in the financial markets or, if not so authorised or regulated, whose corporate purpose is solely to invest in securities;
- (c) at any time to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than €43,000,000 and (3) an annual turnover of more than €50,000,000, all as shown in its last annual or consolidated accounts; or
- (d) at any time in any other circumstances which do not require the publication by the relevant Issuer of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression "offer" in relation to any Securities in any Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Securities to be offered so as to enable an investor to decide to purchase or subscribe the Securities, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression "Prospectus Directive" means Directive 2003/71/EC and includes any relevant implementing measure in each relevant Member State.

### **United Kingdom**

#### *In Relation to the Securities*

In relation to each Tranche of Securities, each Distribution Agent subscribing for or purchasing such Securities has represented to, warranted and agreed with, or will represent to, warrant and agree with, the relevant Issuer and, if the Securities are issued by Morgan Stanley Jersey or MSBV, the Guarantor that:

- (a) *Financial promotion*: it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of section 21 of the FSMA) received by it in connection with the issue or sale of any Securities in circumstances in which section 21(1) of the FSMA would not, if it was not an authorised person, apply to the relevant Issuer; and
- (b) *General compliance*: it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to any Securities in, from or otherwise involving the United Kingdom.

**Ireland**

Each Distribution Agent has represented and agreed that:

- (i) to the extent applicable, it will not underwrite the issue of or place the Securities otherwise than in conformity with the provisions of the Irish Investment Intermediaries Act, 1995 (as amended), including, without limitation, Sections 9 and 50 and will conduct itself in accordance with any code of conduct drawn up pursuant to Section 37; and
- (ii) in relation to any Securities having a maturity of less than one year, it has ensured compliance with the requirements of the Notice of the Central Bank of Ireland of Exemptions granted under Section 8(2) of the Central Bank Act 1971, as amended and any other successor or related requirements with respect to the issue of Securities of such maturity.

**Jersey**

Each Distribution Agent has severally represented to, and agreed with, Morgan Stanley Jersey that it will not take any action on behalf of Morgan Stanley Jersey that would result in Morgan Stanley Jersey being required to become registered under the Financial Services (Jersey) Law 1998, as amended.

#### **NO OWNERSHIP BY U.S. PERSONS**

**The Securities may not be legally or beneficially owned by U.S. Persons at any time. Each holder a beneficial owner of a Security hereby represents, as a condition to purchasing or owning the Security, beneficial interest therein, that neither it nor any person for whose account or benefit the Securities are being purchased is located in the United States, is a U.S. Person or was solicited to purchase the Securities while present in the United States. Each holder and each beneficial owner of a Security hereby agrees not to offer, sell or deliver any of the Securities, at any time, directly or indirectly in the U.S. or to any U.S. Person. The term "U.S. Person" will have the meaning ascribed to it in either Regulation S under the Securities Act or the Code.**

## GENERAL INFORMATION

The obligation of a prospective purchaser, including any of the Distribution Agents, to pay for any Securities it has agreed to purchase is subject to the satisfaction of certain conditions which, if not satisfied or waived, would result in the purchaser having no obligation to pay for any of those Securities.

The Securities have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The appropriate code for each issue allocated by Euroclear and Clearstream, Luxembourg will be contained in the applicable Terms. Transactions will normally be effected for settlement not earlier than two business days after the date of the transaction.

For so long as the Program remains in effect or any Securities issued by Morgan Stanley, Morgan Stanley Jersey or MSBV under the Program remain outstanding, the following documents will be available from the date hereof, during usual business hours on any week day, for inspection by physical means at JPMorgan Chase Bank, N.A., Trinity Tower, 9 Thomas More Street, London E1W 1YT, being the London office of the Principal Securities Agent and at J.P. Morgan Bank (Ireland) plc, J.P. Morgan House, International Finance Service Centre, Dublin 1, Ireland Dublin being the office of the Irish Securities Agent and also at the principal executive offices of Morgan Stanley and the registered offices of Morgan Stanley Jersey and MSBV:

- (i) copies of the Distribution Agreement, the Securities Agency Agreement dated 30 November 2000 (as modified and restated on 4 December 2001 and 30 June 2005, and as further modified and restated on 11 July 2006 and as from time to time further modified and/or restated), the accession agreement dated as of 10 June 2002 relating to Morgan Stanley Jersey, the accession agreement dated as of 16 April 2004 relating to MSBV, the Morgan Stanley Deed of Covenant, the MSJ Deed of Covenant, the MSBV Deed of Covenant, the guarantee dated 10 June 2002 provided by Morgan Stanley, all of Morgan Stanley Jersey's and MSBV's future published financial statements and all of Morgan Stanley's future Annual, Quarterly and Current Reports. Morgan Stanley's Quarterly Reports on Form 10-Q contain unaudited quarterly financial statements;
- (ii) the Certificate of Incorporation and Memorandum and Articles of Association of Morgan Stanley Jersey (these shall not be available at the registered office of MSBV);
- (iii) the Deed of Incorporation of MSBV (this shall not be available at the registered office of Morgan Stanley Jersey);
- (iv) the Certificate of Incorporation and Amended and Restated By-laws of Morgan Stanley;
- (v) all reports, letters and other documents, balance sheets, valuations and statements by any expert any part of which is included or referred to herein;
- (vi) the audited accounts of MSBV for the financial years ended 30 November 2004 and 30 November 2005 (these shall not be available at the registered office of Morgan Stanley Jersey);
- (vii) the audited accounts of Morgan Stanley Jersey for the financial years ended 30 November 2004 and 30 November 2005 (these shall not be available at the registered office of MSBV);
- (viii) Morgan Stanley's Annual Report on Form 10-K for the year ended 30 November 2005, including any amendments thereto, which contain the audited consolidated financial statements of Morgan Stanley for the years ended 30 November 2005 and 30 November 2004;
- (ix) a copy of this document;
- (x) any supplement to this Base Prospectus; and

- (xi) any Final Terms (relating to listed and outstanding issues of Securities) issued after the date of this Base Prospectus.

### **Morgan Stanley**

The Program was authorised by Morgan Stanley pursuant to resolutions adopted at a meeting of the Board of Directors of Morgan Stanley held on 17 June 2003, as amended and updated pursuant to resolutions adopted at a meeting of the Board of Directors of Morgan Stanley held on 14 December 2004 and further amended by resolutions dated 20 September 2005.

### **Morgan Stanley Jersey**

There are no, nor have there been any legal, governmental or arbitration proceedings (including any such proceedings which are pending or threatened of which Morgan Stanley Jersey is aware), during the 12 month period before the date of this Base Prospectus, involving Morgan Stanley Jersey which may have or have had in the recent past, a significant effect on the financial position or profitability of Morgan Stanley Jersey.

Deloitte & Touche, Chartered Accountants and Registered Auditors (authorised and regulated by the Financial Services Authority for designated investment business) of PO Box 403, Lord Coutanche House, 66-68 Esplanade, St Helier, Jersey JE4 8WA have audited the financial statements of Morgan Stanley Jersey for the years ended 30 November 2003, 2004 and 2005 and unqualified opinions have been reported thereon.

Morgan Stanley Jersey does not publish interim financial statements.

The role of Morgan Stanley Jersey as issuer under the Program was authorised by resolutions of the Board of Directors of Morgan Stanley Jersey passed on 7 June 2002 and 10 July 2006.

Morgan Stanley Jersey has obtained or will obtain all necessary consents, approvals and authorisations in connection with the issue and performance of Securities. In particular, the Jersey Financial Services Commission (the "**Commission**") has given, and has not withdrawn, its consent under Article 4 of the Control of Borrowing (Jersey) Order 1958 to the issue of Securities under the Program by Morgan Stanley Jersey. The Commission is protected by the Control of Borrowing (Jersey) Law 1947 against liability arising from the discharge of its functions under that law.

A copy of this document has been delivered to the Jersey registrar of companies in accordance with Article 5 of the Companies (General Provisions) (Jersey) Order 2002, and the registrar has given, and has not withdrawn, consent to its circulation.

It must be distinctly understood that, in giving these consents, neither the registrar of companies nor the Commission takes any responsibility for the financial soundness of Morgan Stanley Jersey or for the correctness of any statements made, or opinions expressed, with regard to it.

If you are in any doubt about the contents of this document you should consult your stockbroker, bank manager, solicitor, accountant or other financial adviser.

It should be remembered that the price of securities and the income from them can go down as well as up.

### **Financial Services (Jersey) Law 1998**

Nothing in this Base Prospectus, any Final Terms or anything communicated to the holders of Securities issued by Morgan Stanley Jersey or potential holders of such securities by or on behalf of Morgan Stanley Jersey is intended to constitute or should be construed as advice on the merits of the purchase of or subscription for such securities or the exercise of any rights attached thereto for the purposes of the Financial Services (Jersey) Law 1998, as amended.

## **Collective Investment Funds (Restriction of Scope) (Jersey) Order 2000**

**The Securities issued by Morgan Stanley Jersey described in this document do not constitute a collective investment fund for the purpose of the Collective Investment Funds (Jersey) Law 1988, as amended, on the basis that they are investment products designed for financially sophisticated investors with specialist knowledge of, and experience of investing in, such investments, who are capable of fully evaluating the risks involved in making such investments and who have an asset base sufficiently substantial as to enable them to sustain any loss that they might suffer as a result of making such investments. These investments are not regarded by the Jersey Financial Services Commission as suitable investments for any other type of investor.**

**Any individual intending to invest in any investment described in this document should consult his or her professional adviser and ensure that he or she fully understands all the risks associated with making such an investment and has sufficient financial resources to sustain any loss that may arise from it.**

### **MSBV**

There are no, nor have there been any legal, governmental or arbitration proceedings (including any such proceedings which are pending or threatened of which MSBV is aware), during the 12 month period before the date of this Base Prospectus, involving MSBV which may have or have had in the recent past, a significant effect on the financial position or profitability of MSBV.

Deloitte Accountants B.V., independent auditors and certified public accountants (members of the Royal Netherlands Institute of Registered Accountants) of Orlyplein 50, 1043 DP Amsterdam, The Netherlands have audited the financial statements of MSBV for the years ended 30 November 2003, 30 November 2004 and 30 November 2005 and an unqualified opinion has been reported thereon.

The financial information in respect of MSBV has been prepared in accordance with United Kingdom accounting standards, as permitted by the Civil Code of the Netherlands on the basis of MSBV's international connections. Such financial information has not been prepared in accordance with the international accounting standards adopted pursuant to the procedure of Article 3 of Regulation (EC) No 1606/2002 and there may be material differences in such financial information had Regulation (EC) No 1606/2002 been applied to such historical financial information.

MSBV does not publish interim financial statements.

The role of MSBV as issuer under the Program was authorised by resolutions of the Board of Directors of MSBV passed on 16 April 2004 and 11 July 2006.

**PRINCIPAL EXECUTIVE OFFICES OF  
MORGAN STANLEY**

1585 Broadway  
New York, New York 10036  
U.S.A.  
Tel: +1 (212) 761 4000

**REGISTERED OFFICE OF MORGAN  
STANLEY IN DELAWARE**

The Corporation Trust Center  
1209 Orange Street  
Wilmington, Delaware 19801  
U.S.A.

**REGISTERED OFFICE OF MORGAN STANLEY (JERSEY) LIMITED**

22 Grenville Street  
St. Helier  
Jersey  
JE4 8PX  
Channel Islands  
Tel: +44 (0) 1534 609000

**REGISTERED OFFICE OF MORGAN STANLEY B.V.**

Locatellikade 1  
1076 AZ Amsterdam  
The Netherlands  
Tel: +31 20 57 55 600

**PRINCIPAL SECURITIES AGENT**

JPMorgan Chase Bank, N.A.  
Trinity Tower  
9 Thomas More Street  
London E1W 1YT  
U.K.

**IRISH SECURITIES AGENT**

J.P. Morgan Bank (Ireland) plc  
J.P. Morgan House  
International Finance Service Centre  
Dublin 1  
Ireland

**LEGAL ADVISORS TO THE ISSUERS**

*As to English law:*

Clifford Chance  
Limited Liability Partnership  
10 Upper Bank Street  
Canary Wharf  
London E14 5JJ  
U.K.

*As to U.S. law:*

Davis Polk & Wardwell  
450 Lexington Avenue  
New York, New York 10017  
U.S.A.

*As to Jersey law:*

Mourant du Feu & Jeune  
PO Box 87  
22 Grenville Street  
St Helier  
Jersey JE4 8PX  
Channel Islands

*As to Netherlands law:*

FreshfieldsBruckhaus Deringer  
Apollolaan 151  
1077 Amsterdam  
The Netherlands

**LEGAL ADVISORS TO THE DISTRIBUTION AGENTS**

*As to English law:*

Lovells  
Atlantic House  
Holborn Viaduct  
London EC1A 2FG

**IRISH LISTING AGENT**

Morgan Stanley & Co. International Limited

25 Cabot Square  
Canary Wharf  
London E14 4QA  
U.K.

*In conjunction with:*

J.P. Morgan Bank (Ireland) plc  
J.P. Morgan House  
International Finance Service Centre  
Dublin 1  
Ireland

**AUDITORS OF MORGAN STANLEY**

Deloitte & Touche LLP  
Two World Financial Center  
New York, New York 10281  
U.S.A.

**AUDITORS OF MORGAN STANLEY (JERSEY) LIMITED**

Deloitte & Touche  
PO Box 403  
66-68 Esplanade  
St Helier  
JE4 8WA Jersey

**AUDITORS OF MORGAN STANLEY B.V.**

Deloitte Accountants B.V.  
Orlyplein 50  
1043 DP Amsterdam  
The Netherlands

**ANNEX A**

**Morgan Stanley Jersey's Annual Report and Accounts dated 30 November 2005**

**Mourant & Co. Secretaries**  
**PO Box 87**  
**22 Grenville Street**  
**St Helier**  
**Jersey**  
**JE4 8PX**

**MORGAN STANLEY (JERSEY) LIMITED**

**Report and Accounts**

**30 November 2005**



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The Directors present their report and accounts for the year ended 30 November 2005

### **RESULTS AND DIVIDENDS**

The result for the year, after tax, was \$nil (2004: \$16,000 loss). During the year, no dividends were paid (2004: \$nil). \$nil (2004:\$16,000 loss) will be carried from reserves.

### **PRINCIPAL ACTIVITY AND REVIEW OF THE BUSINESS**

The principal activity of Morgan Stanley (Jersey) Limited (the "Company") is the issuance of financial instruments and the hedging of the obligations arising pursuant to such issuances.

The Company's ultimate parent undertaking and controlling entity is Morgan Stanley which, together with the Company and its other subsidiary undertakings, form the Morgan Stanley Group (the "Group").

The profit and loss account for the year is set out on page 4. Both the level of business during the year and the financial position at the end of the year were satisfactory. No significant change in the Company's principal business activity is expected

### **DIRECTORS**

The following Directors held office throughout the year, (except where otherwise shown):

D Bandeen (resigned 7 April 2006)  
S Chamberlain (resigned 14 Dec 2004)  
J Hodes (appointed 7 April 2006)  
C EC Hood (appointed 7 April 2006)  
J Roberts (appointed 13 June 2005)  
R Silva (resigned 13 June 2005)  
M A Weston (appointed 9 February 2006; resigned 30 March 2006)

### **AUDITORS**

Deloitte & Touche have expressed their willingness to continue in office as auditors of the company and a resolution to re-appoint them will be proposed at the forthcoming Annual General Meeting.

**STATEMENT OF DIRECTORS' RESPONSIBILITIES**

Jersey company law requires the Directors to prepare accounts for each financial year which give a true and fair view of the state of affairs of the Company as at the end of the financial year and of the profit or loss of the Company for that period. In preparing those accounts, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed; and
- prepare the accounts on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the accounts comply with the Companies (Jersey) Law 1991. They are also responsible for the system of internal control, safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board on

Director: .....

We have audited the financial statements of Morgan Stanley (Jersey) Limited for the year ended 30 November 2005 which comprise the profit and loss account, balance sheet, cashflow statement and related notes 1 to 15. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Company's members, as a body, in accordance with Article 110 of the Companies (Jersey) Law 1991. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

#### **Respective responsibilities of Directors and auditors**

As described in the Statement of Directors' responsibilities, the Company's Directors are responsible for the preparation of the financial statements in accordance with applicable Jersey Law and United Kingdom accounting standards. Our responsibility is to audit the financial statements in accordance with relevant Jersey legal and regulatory requirements and United Kingdom auditing standards.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies (Jersey) Law 1991. We also report if, in our opinion, the Directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records or if we have not received all the information and explanations we require for our audit.

We read the Directors' report for the above year and consider the implications for our report if we become aware of any apparent misstatements.

#### **Basis of audit opinion**

We conducted our audit in accordance with United Kingdom auditing standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements.

#### **Opinion**

In our opinion the financial statements give a true and fair view of the state of the Company's affairs as at 30 November 2005 and of its result for the year then ended and have been properly prepared in accordance with the Companies (Jersey) Law 1991.

Deloitte & Touche  
Chartered Accountants,  
St Helier,  
Jersey

PROFIT AND LOSS ACCOUNT  
Year Ended 30 November 2005

	Note	2005 \$'000	2004 \$'000
<b>NET REVENUE</b>	2	-	-
Administrative expenses		(8)	-
<b>OPERATING LOSS</b>	4	<u>(8)</u>	<u>-</u>
Interest receivable and similar income	6	231	53
Interest payable and similar charges	7	<u>(223)</u>	<u>(69)</u>
<b>RESULT/(LOSS) RETAINED FOR THE FINANCIAL YEAR</b>	13	<u>-</u>	<u>(16)</u>

All operations were continuing in the current and prior year.

There were no recognised gains or losses during the current or prior year other than those disclosed above. Accordingly no statement of total recognised gains and losses has been prepared.

A reconciliation of the movement in shareholders' funds has been prepared in note 13 to the accounts.

The notes on page 7 to 13 form an integral part of the accounts.

BALANCE SHEET  
30 November 2005

	Note	2005 \$'000	2004 \$'000
<b>CURRENT ASSETS</b>			
Financial instruments	11	3,592,925	4,755,776
Debtors	9	5,298	2,764
		<u>3,598,223</u>	<u>4,758,540</u>
<b>CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR</b>			
Financial instruments	11	(2,401,177)	(1,730,222)
Other creditors	10	(4,842)	(2,308)
		<u>(2,406,019)</u>	<u>(1,732,530)</u>
<b>NET CURRENT ASSETS</b>		<u>1,192,204</u>	<u>3,026,010</u>
<b>CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR</b>			
		(1,191,748)	(3,025,554)
		<u>456</u>	<u>456</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital	12	14	14
Profit and loss account	13	442	442
		<u>456</u>	<u>456</u>

These accounts were approved by the Board on

Signed on behalf of the Board

Director

The notes on pages 7 to 13 form an integral part of the accounts.

CASH FLOW STATEMENT  
Year Ended 30 November 2005

	Note	2005 \$'000	2004 \$'000
<b>NET CASH INFLOW FROM OPERATING ACTIVITIES</b>	a)	-	-
<b>INCREASE/(DECREASE) IN CASH IN THE YEAR</b>		<u>-</u>	<u>-</u>

**NOTES****a) Reconciliation of operating profit to net cash inflow from operating activities**

Operating Loss	(8)	-
Increase in debtors	(2,526)	(74)
Increase in creditors	2,534	74
<b>Net cash inflow /(outflow) from operating activities</b>	<u>-</u>	<u>-</u>

## **1. ACCOUNTING POLICIES**

### **a) Accounting convention**

The accounts are prepared under the historical cost convention, modified by the inclusion of financial instruments at fair value as described in note 1(d) below, and in accordance with applicable Jersey law and accounting standards.

### **b) Functional currency**

The accounts are prepared in US dollars, the currency of the primary economic environment in which the Company operates.

All currency amounts in the Director's Report, the Accounts and the Notes to the Accounts are rounded to the nearest thousand US dollars.

### **c) Foreign currencies**

All monetary assets and liabilities denominated in currencies other than US dollars are translated into US dollars at the rates ruling at the balance sheet date. Transactions in currencies other than US dollars are recorded at the rates ruling at the dates of the transactions. Translation differences are taken through the profit and loss account.

### **d) Financial instruments**

Financial instruments, including cash and derivative products, used in the Company's trading activities are recorded at trade date and are recorded at fair value. Subsequent change in fair value are reflected in net revenue in the profit and loss account. 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 distressed sale.

The price transparency of a particular product will determine the degree of judgment involved in determining the fair value of the financial instrument. Price transparency is affected by a wide range 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 than products that are thinly traded or not quoted. Products that are thinly traded or not quoted generally have little or no price transparency.

A substantial percentage of the fair value of the Company's financial instruments are based on observable market prices or 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. In these cases, fair value is determined using techniques appropriate for each particular product. These analyses involve some degree of judgment.

The fair value of over-the-counter ("OTC") derivative contracts is derived from pricing models, which may require multiple market input parameters. The Company also uses pricing models to manage the risk introduced by these transactions. The term "model" typically refers to a mathematical calculation methodology based on accepted financial theories. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modelled 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 in line with those widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as quoted market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

It is the policy and objective of the Company not to be exposed to market, interest rate or currency risk. On the issuance of each financial instrument, the Company hedges its obligations by purchasing financial instruments, including derivative contracts. All assets and liabilities are held in the trading book of the Company.

**e) Netting**

All assets and liabilities have been disclosed gross unless the Company's ability to insist on net settlement is assured beyond doubt.

**2. NET REVENUE**

Net revenue represents net trading income relating to the issuance of financial instruments including net coupons payable and trading interest and is recorded on a trade date basis.

**3. SEGMENTAL REPORTING**

The Directors are of the opinion that it would be seriously prejudicial to the interests of the Company to give separate disclosure in respect of each geographical market within which it operates. The Company has only one class of business, as described in the Directors' Report.

**4. OPERATING LOSS**

	<b>2005</b>	<b>2004</b>
	<b>\$'000</b>	<b>\$'000</b>
Operating loss is stated after charging :		
Auditors' remuneration - audit fees	<u>8</u>	<u>-</u>

The audit fee was borne by another group company in the prior year.

**5. STAFF COSTS**

The Company employed no staff during the year (2004: nil). The Directors did not receive any remuneration for their qualifying services to the Company during the year (2004: \$nil).

**6. OTHER INTEREST RECEIVABLE AND SIMILAR INCOME**

	<b>2005</b>	<b>2004</b>
	<b>\$'000</b>	<b>\$'000</b>
Foreign exchange gains	55	-
Interest receivable from Group undertakings	<u>176</u>	<u>53</u>
	<u>231</u>	<u>53</u>

**7. INTEREST PAYABLE AND SIMILAR CHARGES**

	<b>2005</b> <b>\$'000</b>	<b>2004</b> <b>\$'000</b>
Foreign exchange losses	-	13
Interest payable to Group undertakings	<u>223</u>	<u>56</u>
	<u><u>223</u></u>	<u><u>69</u></u>

**8. TAX ON RESULT/(LOSS) ON ORDINARY ACTIVITIES**

The Company has been granted exempt company status in Jersey. This status warrants an annual fee, which has been borne by another group company.

**9. DEBTORS**

	<b>2005</b> <b>\$'000</b>	<b>2004</b> <b>\$'000</b>
Amounts due from Group undertakings	<u>5,298</u>	<u>2,764</u>
	<u><u>5,298</u></u>	<u><u>2,764</u></u>

**10. OTHER CREDITORS : AMOUNTS FALLING DUE WITHIN ONE YEAR**

	<b>2005</b> <b>\$'000</b>	<b>2004</b> <b>\$'000</b>
Other amounts owing to Group undertakings	<u>4,842</u>	<u>2,308</u>
	<u><u>4,842</u></u>	<u><u>2,308</u></u>

**11. FINANCIAL INSTRUMENTS**

Included within financial instruments acquired are option agreements with other Group companies.

Included within financial instruments sold are notes and certificates which are equity linked instruments where the amount paid at maturity is determined by reference to an independent equity index, basket of equities or single equity stock. For certain notes and certificates, this may require delivery of the physical reference instrument and the amount the holder receives at maturity may be subject to a cap or a floor. Notes and certificates cover a range of major currencies.

Short-term debtors and creditors have been omitted from all disclosures other than currency risk profile.

**MATURITY PROFILE**

The maturity profile of the financial instruments owned and sold is set out below:

	<b>Within one year \$'000</b>	<b>Between one and two years \$'000</b>	<b>Between two and five years \$'000</b>	<b>More than five years \$'000</b>	<b>Total \$'000</b>
<b>2005</b>					
Financial Instruments sold	(2,401,177)	(301,560)	(866,995)	(23,193)	(3,592,925)
	=====	=====	=====	=====	=====
Financial Instruments owned	2,401,177	301,560	866,995	23,193	3,592,925
	=====	=====	=====	=====	=====
<b>2004</b>					
Financial Instruments sold	(1,730,222)	(2,955,171)	(46,356)	(24,027)	(4,755,776)
	=====	=====	=====	=====	=====
Financial Instruments owned	1,730,230	2,955,166	46,356	24,024	4,755,776
	=====	=====	=====	=====	=====

**11. FINANCIAL INSTRUMENTS (CONTINUED)****INTEREST RATE RISK**

					Fixed rate		Non- interest bearing
	Total	Floating rate	Fixed rate	Non- interest bearing	Weighted average interest rate	Weighted average period for which the rate is fixed Years	Weighted average period until maturity Years
	\$'000	\$'000	\$'000	\$'000	%		
<b>Financial Assets</b>							
At 30 November 2005							
Financial instruments owned	3,592,925	-	-	3,592,925	-	-	7.33
	=====	=====	=====	=====	=====	=====	=====
At 30 November 2004							
Financial instruments owned	4,755,776	6,897	-	4,748,879	-	-	0.60
	=====	=====	=====	=====	=====	=====	=====
<b>Financial Liabilities</b>							
At 30 November 2005							
Financial instruments sold	3,592,925	-	-	3,592,925	-	-	7.33
	=====	=====	=====	=====	=====	=====	=====
At 30 November 2004							
Financial instruments sold	4,755,776	6,897	-	4,748,879	-	-	0.60
	=====	=====	=====	=====	=====	=====	=====

**11. FINANCIAL INSTRUMENTS (CONTINUED):**

	<b>Fair and Book value 2005 \$'000</b>	<b>Fair and Book value 2004 \$'000</b>
Financial Instruments owned	3,592,925	4,755,776
Financial Instruments sold	(3,592,925)	(4,755,776)

As all financial instruments are recorded at fair value, there are no unrecognised gains and losses on hedges and, consequently, an analysis of unrecognised gains and losses has not been provided.

The fair value of derivative instruments has been determined using an appropriate option pricing model.

**CURRENCY RISK PROFILE**

The Company's functional currency is US dollars. It is the policy of the Company not to be significantly exposed to foreign exchange rate risk, therefore no currency risk profile has been provided.

**12. CALLED UP SHARE CAPITAL**

	<b>2005 Number</b>	<b>2004 Number</b>
<b>Authorised:</b>		
<b>Equity shares</b>		
10,000 ordinary shares of £1 each	10,000	10,000
	<b>2005 \$'000</b>	<b>2004 \$'000</b>
<b>Allotted and fully paid :</b>		
<b>Equity shares</b>		
10,000 ordinary shares of £1 each	14	14

All ordinary shares are recorded at the rates of exchange ruling at the date the shares were paid up.

### 13. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES

	<b>Called up share capital \$'000</b>	<b>Profit and loss account \$'000</b>	<b>Total \$'000</b>
At 1 December 2003	14	458	472
Loss for the year	-	(16)	(16)
At 1 December 2004	14	442	456
Result for the year	-	-	-
At 30 November 2005	14	442	456

### 14. RELATED PARTY TRANSACTIONS

The Company is exempt from the requirement to disclose transactions with fellow Group undertakings under paragraph 3(c) of FRS 8 *Related Party Disclosures*. There were no other related party transactions requiring disclosure.

### 15. PARENT UNDERTAKINGS

The ultimate parent undertaking and controlling entity and the largest group of which the Company is a member and for which group accounts are prepared is Morgan Stanley. Morgan Stanley is incorporated in Delaware, the United States of America and copies of its accounts can be obtained from 25 Cabot Square, Canary Wharf, London E14 4QA.

The parent undertaking of the smallest group of companies for which group accounts are drawn up and of which the Company is a member is Morgan Stanley International Limited which is registered in England and Wales. Copies of its accounts can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Maindy, Cardiff CF14 3UZ.

**ANNEX B**

**MSBV's Annual Report and Accounts dated 30 November 2005**

**Morgan Stanley B.V.**

**Amsterdam**

**Annual report and Accounts**

**30 November 2005**

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The Directors present their report and accounts for the year ended 30 November 2005.

### **RESULTS AND DIVIDENDS**

The loss for the year, after tax, was €945,688 (2004: €2,397,203 profit). During the year, no dividends were paid (2004: Nil). The loss of €945,688 will be carried from reserves (2004: €2,397,203 profit was carried to reserves).

### **PRINCIPAL ACTIVITY AND REVIEW OF THE BUSINESS**

The principal activity of Morgan Stanley B.V. (the "Company") is the issuance of financial instruments and the hedging of obligations pursuant to such issuances.

The Company's ultimate parent undertaking and controlling entity is Morgan Stanley which, together with the Company and its other subsidiary undertakings, form the Morgan Stanley Group (the "Group").

The profit and loss account for the year is set out on page 2. Both the level of business during the year and the financial position at the end of the year were satisfactory. No significant change in the Company's principal business activity is expected.

### **DIRECTORS**

The following Directors held office throughout the year (except where otherwise shown):

M.B. Burgess (resigned 21 April 2006)  
G.C. De Boer  
B. Hu (resigned 17 March 2005)  
C.E.C. Hood (appointed 17 March 2005)  
J. Solan (appointed 21 April 2006)  
TMF Management B.V.

### **DIRECTORS' INTERESTS**

The Directors had no disclosable interests in the share and loan capital of any Group company at the beginning of the year, at the date of their appointment during the year, or at the end of the year.

### **AUDITORS**

Deloitte Accountants B.V. have expressed their willingness to continue in office as auditors of the company and a resolution to re-appoint them will be proposed at the forthcoming Annual General Meeting.

By order of the Board on --April 2006

Directors

PROFIT AND LOSS ACCOUNT  
Year ended 30 November 2005

	Note	2005 €'000	2004 €'000
<b>NET REVENUE</b>	2	(1,614)	3,638
Administrative expenses	3	<u>(9)</u>	<u>(7)</u>
<b>OPERATING (LOSS)/PROFIT</b>		(1,623)	3,631
Other interest receivable and similar income	5	<u>148</u>	<u>29</u>
<b>(LOSS)/PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION</b>		(1,475)	3,660
Tax on (loss)/profit on ordinary activities	6	<u>529</u>	<u>(1,263)</u>
<b>(LOSS)/PROFIT RETAINED FOR THE FINANCIAL YEAR</b>		<u><u>(946)</u></u>	<u><u>2,397</u></u>

All operations were continuing in the current and prior year.

There were no recognised gains or losses during the current year or prior year other than those disclosed above. Accordingly, no statement of total recognised gains and losses has been prepared.

A reconciliation of the movement in shareholders' funds has been prepared in note 12 to the accounts.

The notes on page 5 to 10 form an integral part of the accounts.

## BALANCE SHEET

30 November 2005

(Including proposed appropriation of net result)

	Note	2005 €'000	2004 €'000
<b>CURRENT ASSETS</b>			
Financial instruments	10	639,273	411,379
Debtors	7	2,686	4,322
Cash at bank		15	14
		<u>641,974</u>	<u>415,715</u>
<b>CREDITORS : AMOUNTS FALLING DUE WITHIN ONE YEAR</b>			
Financial instruments	10	(636,427)	(125,164)
Other creditors	8	(305)	(994)
		<u>(636,732)</u>	<u>(126,158)</u>
<b>NET CURRENT ASSETS</b>		5,242	289,557
<b>CREDITORS : AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR</b>			
	10	(2,846)	(286,215)
		<u>2,396</u>	<u>3,342</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital	11	18	18
Profit and loss account	12	2,378	3,324
<b>EQUITY SHAREHOLDERS' FUNDS</b>		<u>2,396</u>	<u>3,342</u>

These accounts were approved by the Board on --April 2006

Signed on behalf of the Board

Director

The notes on pages 5 to 10 form an integral part of the accounts.

CASH FLOW STATEMENT  
Year ended 30 November 2005

	Note	2005 €'000	2004 €'000
<b>NET CASH INFLOW FROM OPERATING ACTIVITIES</b>	a)	2,319	1,012
<b>TAXATION</b>	b)	(2,318)	(1,013)
<b>INCREASE/(DECREASE) IN CASH IN THE YEAR</b>		<u><u>1</u></u>	<u><u>(1)</u></u>

**NOTES****a) Reconciliation of operating profit to net cash inflow from operating activities**

Operating profit/(Loss)	(1,623)	3,631
Decrease/(increase) in financial instruments	-	-
Decrease/(increase) in debtors	3,894	(2,619)
Increase in creditors	48	-
<b>Net cash inflow /(outflow) from operating activities</b>	<u><u>2,319</u></u>	<u><u>1,012</u></u>

**b) Gross cash flows****Taxation**

UK corporation tax paid	-	-
Foreign tax paid	2,318	1,013
	<u><u>2,318</u></u>	<u><u>1,013</u></u>

## 1. 1. ACCOUNTING POLICIES

### a) Accounting convention

The accounts are prepared under the historical cost convention, modified by the inclusion of financial instruments at fair value as described in note 1(d) below, and in accordance with applicable United Kingdom accounting standards as permitted by Article 362.1 of Title 9 of Book 2 of the Netherlands Civil Code on the basis of the Company's international connections.

### b) Functional currency

The accounts are prepared in Euros, the currency of the primary economic environment in which the Company operates.

### c) Foreign currencies

All monetary assets and liabilities denominated in currencies other than Euros are translated into Euros at the rates ruling at the balance sheet date. Transactions in currencies other than Euros are recorded at the rates ruling at the dates of the transactions. All translation differences are taken through the profit and loss account.

### d) Current assets - financial instruments

Financial instruments, including cash and derivative products, used in the Company's trading activities are recorded on trade date and are recorded at fair value. Subsequent changes in fair value are reflected in net revenue in the profit and loss account. 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 price transparency of a particular product will determine the degree of judgment involved in determining the fair value of the financial instrument. Price transparency is affected by a wide range 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 generally have little or no price transparency.

A substantial percentage of the fair value of the Company's financial instruments is based on observable market prices or observable market parameters, or is derived directly 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 fair value of over-the-counter ("OTC") derivative contracts is derived primarily from pricing models, which may require multiple market input parameters. Where appropriate, valuation adjustments are made to account for credit quality and market liquidity. These adjustments are applied on a consistent basis and are based upon observable market data where available. The Company also uses pricing models to manage the risks introduced by these transactions. The term "model" typically refers to a mathematical calculation methodology based on accepted financial theories. Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be modelled 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 in line with those widely accepted by the financial services industry. Pricing models take into account the contract terms, including the maturity, as well as quoted market parameters such as interest rates, volatility and the creditworthiness of the counterparty.

It is the policy and objective of the Company not to be exposed to market, interest rate or currency risk. On the issuance of each financial instrument, the Company hedges its obligations by purchasing financial instruments, including derivative contracts. All assets and liabilities are held in the trading book of the Company.

**e) Netting**

All assets and liabilities have been disclosed gross unless the Company's ability to insist on net settlement is assured beyond doubt.

**2. NET REVENUE**

Net revenue represents net trading income relating to the issuance of financial instruments including issuance fees receivable less guarantee fees payable in the period and is recorded on a trade date basis.

During the period, transfer pricing agreements governing this arrangement were revised. This resulted in a current year reduction to revenues booked in the prior year of €2,884,000.

**3. ADMINISTRATIVE EXPENSES**

	<b>2005</b> <b>€'000</b>	<b>2004</b> <b>€'000</b>
Operating (loss)/profit is stated after charging :		
Auditors' remuneration - audit fees	<u>9</u>	<u>7</u>

**4. STAFF COSTS**

The Company employed no staff during the year (2004: Nil).

The Directors did not receive any remuneration for their qualifying services to the Company during the year (2004: Nil).

**5. OTHER INTEREST RECEIVABLE AND SIMILAR INCOME**

	<b>2005</b> <b>€'000</b>	<b>2004</b> <b>€'000</b>
Interest receivable from Group undertakings	<u>148</u>	<u>29</u>

Interest receivable excludes trading interest, which is included in net revenue since it is an integral component of the Company's net trading income.

**6. TAX ON PROFIT/LOSS ON ORDINARY ACTIVITIES****Analysis of (credit)/charge in the year**

	<b>2005</b> <b>€'000</b>	<b>2004</b> <b>€'000</b>
Dutch corporation income tax at 31.75% (2004: - 34.5%)		
- Current year	468	1,263
- Prior year adjustments	<u>(997)</u>	<u>-</u>
	<u>(529)</u>	<u>1,263</u>

The current year Dutch taxation charge is equal to that resulting from applying the standard Dutch corporation income tax rate of 31.75% (2004: 34.5%).

**7. DEBTORS**

	<b>2005</b> <b>€'000</b>	<b>2004</b> <b>€'000</b>
Amounts due from Group undertakings	575	4,322
Corporation tax	<u>2,111</u>	<u>-</u>
	<u><u>2,686</u></u>	<u><u>4,322</u></u>

**8. OTHER CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR**

	<b>2005</b> <b>€'000</b>	<b>2004</b> <b>€'000</b>
Amounts owing to Group undertakings	305	257
Corporation tax	<u>-</u>	<u>737</u>
	<u><u>305</u></u>	<u><u>994</u></u>

**9. NETTING**

Under the terms of a netting agreement between an affiliated entity, Morgan Stanley & Co International Limited ("MSIL") and the Company, amounts due to MSIL under financial instruments issued by the company have been set off against the the amounts due under the corresponding financial instruments purchased from MSIL as follows:

	<b>2005</b> <b>€'000</b>	<b>2004</b> <b>€'000</b>
Financial instruments	2,196,805	2,124,165
Financial instruments issued	<u>(2,196,805)</u>	<u>(2,124,165)</u>
	<u><u>-</u></u>	<u><u>-</u></u>

**10. FINANCIAL INSTRUMENTS****INTEREST RATE RISK AND MATURITY PROFILE**

The following table analyses the assets and liabilities of the Company as at 30 November 2005 in time bands according to the next interest rate pricing date or the maturity date:

	<b>In less than one year</b>	<b>In more than one year but not more than two years</b>	<b>More than two years but less than five years</b>	<b>More than five years</b>	<b>Total</b>
	<b>€'000</b>	<b>€'000</b>	<b>€'000</b>	<b>€'000</b>	<b>€'000</b>
<b>2005</b>					
Financial instruments	636,427	-	2,846	-	639,273
Financial instruments issued	(636,427)	-	(2,846)	-	(639,273)
<b>As at 30 November 2005</b>	-	-	-	-	-
	<b>€'000</b>	<b>€'000</b>	<b>€'000</b>	<b>€'000</b>	<b>€'000</b>
<b>2004</b>					
Financial instruments	125,164	-	2,000	284,215	411,379
Financial instruments issued	(125,164)	-	(2,000)	(284,215)	(411,379)
<b>As at 30 November 2004</b>	-	-	-	-	-

The above analysis and the fair value analysis set out below exclude amounts due from group undertakings of €575,000 (2004: €4,322,000), other debtors of €2,111,000 (2004: Nil), due to group undertakings of €305,000 (2004: €257,000), cash at bank of €15,000 (2004: €14,000) and other creditors of Nil (2004: €737,000).

The coupon payable on the financial instruments issued is zero and is identical in risk profile to the interest receivable on the financial instruments used to hedge these instruments.

**CURRENCY RISK PROFILE**

The company's functional currency is the Euro. It is the policy of the Company not to be exposed to foreign exchange rate risk. All foreign exchange risk is hedged into Euros.

**FAIR VALUE**

	<b>Year ended 30 November 2005 €'000</b>	<b>Year ended 30 November 2004 €'000</b>
Financial instruments	639,273	411,379
Financial instruments issued	<u>(639,273)</u>	<u>(411,379)</u>
	<u>-</u>	<u>-</u>

The fair value of the financial instruments is determined using an appropriate option pricing model (as described in the 'Financial Instruments' note, page 5).

**11. CALLED UP SHARE CAPITAL**

	<b>2005 Number</b>	<b>2004 Number</b>
<b>Authorised:</b>		
<b>Equity shares</b>		
900 ordinary shares of €100 each	<u>900</u>	<u>900</u>
	<b>2005 €'000</b>	<b>2004 €'000</b>
<b>Allotted and fully paid:</b>		
<b>Equity shares</b>		
180 ordinary shares of €100 each	<u>18</u>	<u>18</u>

All ordinary shares are recorded at the rates of exchange ruling at the date the shares were paid up.

**12. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES**

	<b>Called up share capital €'000</b>	<b>Profit and loss account €'000</b>	<b>Total €'000</b>
At 1 December 2003	18	927	945
Profit for the year	-	2,397	2,397
At 1 December 2004	<u>18</u>	<u>3,324</u>	<u>3,342</u>
Loss for the year	-	(946)	(946)
At 30 November 2005	<u>18</u>	<u>2,378</u>	<u>2,396</u>

**13. COMMITMENTS AND CONTINGENCIES**

As at 30 November 2005, the right, title and interest of the issuer in financial instruments with a value of €639,273,000 (2004: €411,379,000) has been assigned absolutely by way of security to and in favour of an affiliated entity, Morgan Stanley A.G. under terms of a security assignment agreement.

**14. RELATED PARTY TRANSACTIONS**

The Company is exempt from the requirement to disclose transactions with fellow Group undertakings under paragraph 3(c) of FRS 8 *Related Party Disclosures*. There were no other related party transactions requiring disclosure.

**15. PARENT UNDERTAKINGS**

The ultimate parent undertaking and controlling entity and the largest group of which the Company is a member and for which group accounts are prepared is Morgan Stanley. Morgan Stanley is incorporated in Delaware, the United States of America and copies of its accounts can be obtained from 25 Cabot Square, Canary Wharf, London E14 4QA or Locatellikade 1, 1067 AZ Amsterdam.

Date

Directors

**Statutory rules concerning appropriation of the net result**

The Articles of Incorporation of the Company provide that the net result for the year is at the disposition of the Annual General Meeting of Shareholders.

**Appropriation of the net result for the period**

Awaiting the decision by the shareholder, the net result for the year ended 30 November 2005 is separately included in the shareholder's equity as profit retained for the period.

**Subsequent events**

No events have occurred since the balance sheet date, which would change the financial position of the Company and which would require adjustment of disclosure in the annual report now presented.

**Annex C**

**Morgan Stanley's Quarterly Report on Form 10-Q  
for the quarterly period ended 31 May 2006**

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

**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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**MORGAN STANLEY**  
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**Quarter Ended May 31, 2006**

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## AVAILABLE INFORMATION

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

**Item 1.**

**MORGAN STANLEY**  
**CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**  
(dollars in millions, except share data)

	May 31, 2006	November 30, 2005
	(unaudited)	
<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
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 .....	—	3,145
Goodwill and net intangible assets .....	2,932	2,500
Other assets .....	17,652	12,796
Total assets .....	\$1,027,043	\$898,523

**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
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
	994,722	869,275
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)
Total shareholders' equity	32,255	29,182
Total liabilities and shareholders' equity	\$1,027,043	\$898,523

See Notes to Condensed Consolidated Financial Statements.

**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)	
Revenues:				
Investment banking .....	\$ 1,132	\$ 814	\$ 2,114	\$ 1,635
Principal transactions:				
Trading .....	3,735	1,794	6,802	3,640
Investments .....	690	226	1,004	379
Commissions .....	1,005	824	1,934	1,648
Fees:				
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
Total revenues .....	<u>19,062</u>	<u>11,801</u>	<u>37,181</u>	<u>23,399</u>
Interest expense .....	9,988	5,561	19,469	10,186
Provision for consumer loan losses .....	130	209	285	344
Net revenues .....	<u>8,944</u>	<u>6,031</u>	<u>17,427</u>	<u>12,869</u>
Non-interest expenses:				
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)
Total non-interest expenses .....	<u>5,768</u>	<u>4,637</u>	<u>11,804</u>	<u>9,380</u>
Income from continuing operations before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net .....	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
Income from continuing operations before cumulative effect of accounting change, net .....	1,949	931	3,543	2,280
Discontinued operations:				
Income/(loss) from discontinued operations .....	14	(5)	(42)	2
Income tax (provision)/benefit .....	(6)	2	17	(1)
Income/(loss) on discontinued operations .....	8	(3)	(25)	1
Cumulative effect of accounting change, net .....	—	—	—	49
Net income .....	<u>\$ 1,957</u>	<u>\$ 928</u>	<u>\$ 3,518</u>	<u>\$ 2,330</u>
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 .....	<u>\$ 1.93</u>	<u>\$ 0.88</u>	<u>\$ 3.46</u>	<u>\$ 2.20</u>
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 .....	<u>\$ 1.86</u>	<u>\$ 0.86</u>	<u>\$ 3.33</u>	<u>\$ 2.15</u>
Average common shares outstanding:				
Basic .....	<u>1,013,241,715</u>	<u>1,053,812,487</u>	<u>1,016,756,096</u>	<u>1,061,632,036</u>
Diluted .....	<u>1,054,733,745</u>	<u>1,079,811,172</u>	<u>1,056,493,761</u>	<u>1,084,988,764</u>

See Notes to Condensed Consolidated Financial Statements.

**MORGAN STANLEY**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(dollars in millions)

	Three Months Ended May 31,		Six Months Ended 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.

**MORGAN STANLEY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(dollars in millions)

	<b>Six Months Ended</b>	
	<b>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
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)
Net cash provided by financing activities .....	<u>24,678</u>	<u>23,160</u>
Net decrease in cash and cash equivalents .....	(14,621)	(7,725)
Cash and cash equivalents, at beginning of period .....	29,414	32,811
Cash and cash equivalents, at end of period .....	<u>\$ 14,793</u>	<u>\$ 25,086</u>

See Notes to Condensed Consolidated Financial Statements.

**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 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. (“MSDWT”), Morgan Stanley Investment Advisors Inc. and NOVUS Credit Services Inc.

## 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 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.

## 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.

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

## 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.

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

## 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.

## 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.

**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:

	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Discover</u>	<u>Total</u>
	(dollars in millions)				
<i>Goodwill:</i>					
<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) .....	<u>2</u>	<u>—</u>	<u>2</u>	<u>232</u>	<u>236</u>
<b>Balance as of May 31, 2006</b> .....	<u>\$446</u>	<u>\$570</u>	<u>\$968</u>	<u>\$504</u>	<u>\$2,488</u>
<i>Intangible assets:</i>					
<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 .....	<u>(13)</u>	<u>—</u>	<u>—</u>	<u>(5)</u>	<u>(18)</u>
<b>Balance as of May 31, 2006</b> .....	<u>\$240</u>	<u>\$—</u>	<u>\$ 4</u>	<u>\$200</u>	<u>\$ 444</u>

(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:

	<u>At May 31, 2006</u>	<u>At November 30, 2005</u>
	(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 .....	<u>5,837</u>	<u>5,290</u>
<b>Total</b> .....	<u>\$54,898</u>	<u>\$39,887</u>

## 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.

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**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 Mortgage Loans</b>	<b>U.S. Agency Collateralized Mortgage Obligations</b>	<b>Commercial Mortgage 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.**

Consumer loans were as follows:

	<b>At May 31, 2006</b>	<b>At November 30, 2005</b>
	(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 . . . . .	<u>\$21,965</u>	<u>\$22,916</u>

**MORGAN STANLEY**

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

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

	<b>Three Months Ended May 31,</b>		<b>Six Months Ended May 31,</b>	
	<b>2006</b>	<b>2005(1)</b>	<b>2006</b>	<b>2005(1)</b>
	(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 . . . . .	<u>\$ 776</u>	<u>\$ 840</u>	<u>\$ 776</u>	<u>\$ 840</u>

(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:

	<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)			
Interest accrued on general purpose credit card loans subsequently charged off, net of recoveries (recorded as a reduction of Interest revenue) . . . . .	<u>\$44</u>	<u>\$50</u>	<u>\$82</u>	<u>\$106</u>
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) . . . . .	<u>\$23</u>	<u>\$27</u>	<u>\$45</u>	<u>\$ 60</u>

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

**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%

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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):

	<u>At May 31, 2006</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):

	<u>Six Months Ended May 31,</u>	
	<u>2006</u>	<u>2005</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
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):

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

## 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.

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.

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**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):

	<u>Three Months Ended May 31,</u>		<u>Six Months Ended May 31,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
<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	<u>\$1,957</u>	<u>\$ 928</u>	<u>\$3,518</u>	<u>\$2,330</u>
Weighted average common shares outstanding	<u>1,013</u>	<u>1,054</u>	<u>1,017</u>	<u>1,062</u>
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	<u>\$ 1.93</u>	<u>\$ 0.88</u>	<u>\$ 3.46</u>	<u>\$ 2.20</u>
<b>Diluted EPS:</b>				
Net income applicable to common shareholders	<u>\$1,957</u>	<u>\$ 928</u>	<u>\$3,518</u>	<u>\$2,330</u>
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	<u>1,055</u>	<u>1,080</u>	<u>1,056</u>	<u>1,085</u>
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	<u>\$ 1.86</u>	<u>\$ 0.86</u>	<u>\$ 3.33</u>	<u>\$ 2.15</u>

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

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

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

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, 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.

## 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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### 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 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.

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**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:

<u>Product Type</u>	<u>At May 31, 2006</u>		<u>At November 30, 2005</u>	
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
	(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
Total . . . . .	<u>\$51,536</u>	<u>\$48,747</u>	<u>\$45,894</u>	<u>\$44,952</u>

**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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

<u>Three Months Ended May 31, 2006</u>	<u>Institutional Securities(1)</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Discover</u>	<u>Intersegment Eliminations(1)</u>	<u>Total</u>
			(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
Net revenues . . . . .	<u>\$5,726</u>	<u>\$1,402</u>	<u>\$723</u>	<u>\$1,191</u>	<u>\$ (98)</u>	<u>\$8,944</u>
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 . . . . .	<u>786</u>	<u>51</u>	<u>89</u>	<u>203</u>	<u>(5)</u>	<u>1,124</u>
Income from continuing operations before cumulative effect of accounting change, net(2) . . . . .	<u>\$1,378</u>	<u>\$ 106</u>	<u>\$135</u>	<u>\$ 338</u>	<u>\$ (8)</u>	<u>\$1,949</u>
<u>Three Months Ended May 31, 2005(3)</u>	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Discover</u>	<u>Intersegment Eliminations</u>	<u>Total</u>
			(dollars in millions)			
Net revenues excluding net interest . . . . .	\$3,300	\$1,149	\$641	\$ 534	\$ (67)	\$5,557
Net interest . . . . .	40	79	1	354	—	474
Net revenues . . . . .	<u>\$3,340</u>	<u>\$1,228</u>	<u>\$642</u>	<u>\$ 888</u>	<u>\$ (67)</u>	<u>\$6,031</u>
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 . . . . .	<u>171</u>	<u>48</u>	<u>68</u>	<u>99</u>	<u>10</u>	<u>396</u>
Income from continuing operations before cumulative effect of accounting change, net(2) . . . . .	<u>\$ 575</u>	<u>\$ 70</u>	<u>\$107</u>	<u>\$ 164</u>	<u>\$ 15</u>	<u>\$ 931</u>



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### 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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### 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 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.

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**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:

<u>Type of Guarantee</u>	<u>Maximum Potential Payout/Notional</u>					<u>Carrying Amount</u>	<u>Collateral/Recourse</u>
	<u>Years to Maturity</u>				<u>Total</u>		
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>			
	(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 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

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**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:

	<u>Three Months Ended May 31,</u>		<u>Six Months Ended May 31,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Losses related to merchant chargebacks (dollars in millions) . . . . .	\$ 1.4	\$ 1.9	\$ 1.9	\$ 3.9
Aggregate credit card transaction volume (dollars in billions) . . . . .	24.8	21.2	48.0	42.0

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**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 May 31, 2006	At 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 May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(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

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**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
Net periodic benefit expense . . . . .	\$ 50	\$ 45	\$100	\$ 90

**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.

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

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

## 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 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.

## 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.

## 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.

## 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

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New York, New York  
July 6, 2006

## 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).

## Results of Operations.

### Executive Summary.

#### Financial Information.

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005(1)	2006	2005(1)
<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)
Consolidated net revenues	<u>\$8,944</u>	<u>\$6,031</u>	<u>\$17,427</u>	<u>\$12,869</u>
<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
Consolidated income before taxes	<u>\$3,176</u>	<u>\$1,394</u>	<u>\$ 5,623</u>	<u>\$ 3,489</u>
<b>Consolidated net income (dollars in millions)</b>	<u>\$1,957</u>	<u>\$ 928</u>	<u>\$ 3,518</u>	<u>\$ 2,330</u>
<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
Earnings per basic share	<u>\$ 1.93</u>	<u>\$ 0.88</u>	<u>\$ 3.46</u>	<u>\$ 2.20</u>
<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
Earnings per diluted share	<u>\$ 1.86</u>	<u>\$ 0.86</u>	<u>\$ 3.33</u>	<u>\$ 2.15</u>
<b>Statistical Data.</b>				
<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
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
Consolidated	<u>\$ 31.2</u>	<u>\$ 28.4</u>	<u>\$ 30.4</u>	<u>\$ 28.4</u>

*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) . . . . .	<u>\$ 625</u>	<u>\$ 565</u>	<u>\$ 625</u>	<u>\$ 565</u>
<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
Pre-tax profit margin(8) . . . . .	40%	24%	36%	26%

*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 . . . . .	<u>\$ 639</u>	<u>\$ 613</u>	<u>\$ 639</u>	<u>\$ 613</u>
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 . . . . .	<u>\$ 28.5</u>	<u>\$ 25.4</u>	<u>\$ 55.4</u>	<u>\$ 51.3</u>
Payment services transaction volume (in millions):				
Discover network . . . . .	340	315	679	629
PULSE network . . . . .	471	457	896	673
Total network transaction volume . . . . .	<u>811</u>	<u>772</u>	<u>1,575</u>	<u>1,302</u>
Pre-tax profit margin(8) . . . . .	45%	30%	45%	33%

- (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.

***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

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

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.**

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.

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.

**INSTITUTIONAL SECURITIES**  
**INCOME STATEMENT INFORMATION**

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(dollars in millions)			
Revenues:				
Investment banking .....	\$ 1,055	\$ 735	\$ 1,958	\$ 1,477
Principal transactions:				
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
Total revenues .....	<u>15,437</u>	<u>8,679</u>	<u>30,092</u>	<u>17,117</u>
Interest expense .....	<u>9,711</u>	<u>5,339</u>	<u>18,892</u>	<u>9,762</u>
Net revenues .....	<u>5,726</u>	<u>3,340</u>	<u>11,200</u>	<u>7,355</u>
Total non-interest expenses .....	<u>3,459</u>	<u>2,527</u>	<u>7,179</u>	<u>5,465</u>
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 .....	<u>786</u>	<u>171</u>	<u>1,309</u>	<u>455</u>
Income from continuing operations before cumulative effect of accounting change, net .....	<u>\$ 1,378</u>	<u>\$ 575</u>	<u>\$ 2,541</u>	<u>\$ 1,295</u>

**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 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.

**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% 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

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).

**GLOBAL WEALTH MANAGEMENT GROUP**  
**INCOME STATEMENT INFORMATION**

	<u>Three Months</u> <u>Ended May 31,</u>		<u>Six Months</u> <u>Ended May 31,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(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 . . . . .	<u>1,518</u>	<u>1,298</u>	<u>2,919</u>	<u>2,596</u>
Interest expense . . . . .	<u>116</u>	<u>70</u>	<u>233</u>	<u>130</u>
Net revenues . . . . .	<u>1,402</u>	<u>1,228</u>	<u>2,686</u>	<u>2,466</u>
Total non-interest expenses . . . . .	<u>1,245</u>	<u>1,110</u>	<u>2,506</u>	<u>1,995</u>
Income before taxes and cumulative effect of accounting change, net . . . . .	157	118	180	471
Provision for income taxes . . . . .	<u>51</u>	<u>48</u>	<u>60</u>	<u>187</u>
Income before cumulative effect of accounting change, net . . . . .	<u>\$ 106</u>	<u>\$ 70</u>	<u>\$ 120</u>	<u>\$ 284</u>

**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.

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.

**ASSET MANAGEMENT**  
**INCOME STATEMENT INFORMATION**

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(dollars in millions)			
Revenues:				
Investment banking	\$ 15	\$ 11	\$ 27	\$ 22
Principal transactions:				
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
Total revenues	728	644	1,427	1,342
Interest expense	5	2	9	4
Net revenues	723	642	1,418	1,338
Total non-interest expenses	499	467	1,022	876
Income before taxes and cumulative effect of accounting change, net	224	175	396	462
Provision for income taxes	89	68	156	175
Income before cumulative effect of accounting change, net	<u>\$135</u>	<u>\$107</u>	<u>\$ 240</u>	<u>\$ 287</u>

**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.

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

	At May 31, 2006	At May 31, 2005(1)	Average For the Three Months Ended		Average For the Six Months Ended	
			May 31, 2006	May 31, 2005(1)	May 31, 2006	May 31, 2005(1)
(dollars in billions)						
Assets under management or supervision by distribution channel:						
Retail .....	\$190	\$199	\$191	\$201	\$195	\$202
Institutional .....	250	217	254	219	248	222
Total assets under management or supervision .....	<u>\$440</u>	<u>\$416</u>	<u>\$445</u>	<u>\$420</u>	<u>\$443</u>	<u>\$424</u>
Assets under management or supervision by asset class:						
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
Total assets under management .....	427	405	432	409	430	413
Unit investment trusts .....	13	11	13	11	13	11
Total assets under management or supervision .....	<u>\$440</u>	<u>\$416</u>	<u>\$445</u>	<u>\$420</u>	<u>\$443</u>	<u>\$424</u>

(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, 2006	May 31, 2005	May 31, 2006	May 31, 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) .....	3	(4)	21	6
Total net (decrease)/increase .....	(2)	(11)	9	(8)
<b>Balance at end of period</b> .....	<u>\$440</u>	<u>\$416</u>	<u>\$440</u>	<u>\$416</u>

Net outflows (excluding money markets) in the quarter and six month period ended May 31, 2006 were primarily associated with the Company's Morgan Stanley branded products, partially offset by positive institutional flows. Net outflows in the six month period ended May 31, 2006 also reflected distributions of assets from the private equity business. For the quarter and six month period ended May 31, 2006, net outflows from Asset Management's money market assets were primarily associated with two retail funds impacted by Global Wealth Management Group's bank deposit program. The net outflows in the six month period ended May 31, 2006 were partially offset by market appreciation and positive flows into institutional liquidity assets.

Asset management, distribution and administration fees increased 1% and 3% in the quarter and six month period ended May 31, 2006, as higher fund management and administration fees associated with a 6% and 4% increase

in average assets under management in the quarter and six month period, respectively, were partly offset by lower distribution and redemption fees. The increase in the six month period was also due to higher performance fees.

***Non-Interest Expenses.*** Non-interest expenses increased 7% and 17% in the quarter and six month period ended May 31, 2006. The increase in both periods primarily reflected an increase in compensation and benefits expense, partially offset by lower non-compensation expenses. The six month period ended May 31, 2005 included a reduction in non-interest expenses from Asset Management's share (\$43 million) of the insurance settlement related to the events of September 11, 2001 (see "Insurance Settlement" herein). Compensation and benefits expense increased 51% and 44% in the quarter and six month period, primarily reflecting higher incentive-based compensation accruals. The six month period ended May 31, 2006 also included Asset Management's share (\$28 million) of the incremental compensation expense related to equity awards to retirement-eligible employees (see "Stock Based-Compensation" herein). Excluding compensation and benefits expense and the insurance settlement, non-interest expenses decreased 18% and 8% in the quarter and six month period. Brokerage, clearing and exchange fees decreased 9% and 13% in the quarter and six month period, primarily reflecting lower amortization expense associated with certain open-ended funds. The decrease in amortization expense reflected a lower level of deferred costs in recent periods due to a decrease in sales of certain open-ended funds. Marketing and business development expense increased 12% in the six month period primarily due to higher promotional costs associated with the Company's Van Kampen products. Professional services expense decreased 13% in the quarter primarily due to lower sub-advisory fees. Other expenses decreased 129% and 61% in the quarter and six month period, primarily due to an insurance reimbursement related to certain legal matters.

**DISCOVER**  
**INCOME STATEMENT INFORMATION**

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(dollars in millions)			
Merchant, cardmember and other fees . . . . .	\$ 277	\$318	\$ 566	\$ 626
Servicing and securitization income . . . . .	651	423	1,247	917
Other revenue . . . . .	5	2	9	4
Total non-interest revenues . . . . .	<u>933</u>	<u>743</u>	<u>1,822</u>	<u>1,547</u>
Interest revenue . . . . .	608	536	1,194	994
Interest expense . . . . .	<u>220</u>	<u>182</u>	<u>451</u>	<u>350</u>
Net interest income . . . . .	388	354	743	644
Provision for consumer loan losses . . . . .	<u>130</u>	<u>209</u>	<u>285</u>	<u>344</u>
Net credit income . . . . .	258	145	458	300
Net revenues . . . . .	<u>1,191</u>	<u>888</u>	<u>2,280</u>	<u>1,847</u>
Total non-interest expenses . . . . .	<u>650</u>	<u>625</u>	<u>1,260</u>	<u>1,230</u>
Income before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net . . . . .	541	263	1,020	617
Losses from unconsolidated investees . . . . .	—	—	1	—
Provision for income taxes . . . . .	<u>203</u>	<u>99</u>	<u>381</u>	<u>233</u>
Income before cumulative effect of accounting change, net . . . . .	<u>\$ 338</u>	<u>\$164</u>	<u>\$ 638</u>	<u>\$ 384</u>

**Merchant, Cardmember and Other Fees.** Merchant, cardmember and other fees decreased 13% and 10% in the quarter and six month period ended May 31, 2006, primarily due to lower net merchant discount revenues and higher net cardmember rewards, partially offset by higher merchant and cardmember fees. The decrease in net merchant discount revenues was due to higher allocations of interchange revenue to securitization transactions, partially offset by record sales volume. For securitization transactions completed on or after November 3, 2004, the Company began allocating interchange revenue to new securitization transactions, which has the effect of decreasing Merchant, cardmember and other fees and increasing Servicing and securitization income. During the quarter and six month period ended May 31, 2006, the Company had a higher level of outstanding securitization transactions receiving interchange allocations than in the comparable fiscal 2005 periods. The increase in sales volume reflected increased cardmember usage and the acquisition of Goldfish in February 2006 (see “Business Acquisitions” herein). The increase in net cardmember rewards reflected record sales volume and the impact of promotional programs. The increase in merchant and cardmember fees primarily relates to lower fee net charge-offs and higher revenues from merchant fees.

**Servicing and Securitization Income.** The table below presents the components of servicing and securitization income:

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
	(dollars in millions)			
Merchant, cardmember and other fees	\$264	\$166	\$ 494	\$ 339
Other revenue	17	(16)	156	16
Total non-interest revenues	281	150	650	355
Interest revenue	968	890	1,857	1,815
Interest expense	356	251	666	484
Net interest income	612	639	1,191	1,331
Provision for consumer loan losses	242	366	594	769
Net credit income	370	273	597	562
Servicing and securitization income	<u>\$651</u>	<u>\$423</u>	<u>\$1,247</u>	<u>\$ 917</u>

Servicing and securitization income increased 54% and 36% in the quarter and six month period ended May 31, 2006, primarily due to higher non-interest revenues and a lower provision for consumer loan losses. The increase in Merchant, cardmember and other fees primarily reflected a higher level of outstanding securitization transactions that received interchange revenues. The increase in Other revenue in both periods was attributable to an increase in the fair value of the Company's retained interests in securitized receivables, primarily resulting from a favorable impact on charge-offs following the enactment of federal bankruptcy legislation that became effective in October 2005. The increase in Other revenue in the six month period also reflected higher levels of general purpose credit card securitization transactions. The lower provision for consumer loan losses in both periods was primarily attributable to a lower level of average securitized general purpose credit card loans and a lower rate of net principal charge-offs on the securitized general purpose credit card loan portfolio. The increase in Servicing and securitization income in the six month period was partially offset by a decrease in net interest cash flows primarily attributable to a lower level of average securitized general purpose credit card loans.

The net proceeds received from general purpose credit card asset securitizations in the six month periods ended May 31, 2006 and 2005 were \$6,613 million and \$3,419 million, respectively. The credit card asset securitization transactions completed in the six month period ended May 31, 2006 have expected maturities ranging from approximately three to seven years from the date of issuance.

**Net Interest Income.** Net interest income increased 10% and 15% in the quarter and six month period ended May 31, 2006 due to an increase in interest revenue, partially offset by an increase in interest expense. The increase in interest revenue in both periods was due to an increase in average owned general purpose credit card loans as well as a higher interest yield. The increase in average owned general purpose credit card loans was due to the acquisition of Goldfish (see "Business Acquisitions" herein) and a lower level of outstanding securitizations. The increase in interest expense in both periods was primarily due to an increase in the Company's average cost of borrowings and a higher level of average interest bearing liabilities, primarily to support the increase in average owned general purpose credit card loans.

The following tables present analyses of Discover's average balance sheets and interest rates for the quarters and six months ended May 31, 2006 and 2005 and changes in net interest income during those periods:

**Average Balance Sheet Analysis.**

	Three Months Ended May 31,					
	2006			2005		
	Average Balance	Rate	Interest	Average Balance	Rate	Interest
	(dollars in millions)					
<b>ASSETS</b>						
Interest earning assets:						
General purpose credit card loans	\$19,664	11.01%	\$ 546	\$18,753	10.56%	\$ 499
Other consumer loans	214	7.43	4	404	7.53	8
Investment securities	59	3.97	1	52	1.78	—
Other	4,265	5.32	57	3,294	3.46	29
Total interest earning assets	24,202	9.95	608	22,503	9.45	536
Allowance for loan losses	(785)			(848)		
Non-interest earning assets	2,682			2,475		
Total assets	<u>\$26,099</u>			<u>\$24,130</u>		
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>						
Interest bearing liabilities:						
Interest bearing deposits						
Savings	\$ 1,579	4.54%	\$ 18	\$ 656	2.57%	\$ 4
Brokered	10,931	4.55	125	9,933	4.37	109
Other time	1,759	4.49	20	2,374	3.63	22
Total interest bearing deposits	14,269	4.54	163	12,963	4.15	135
Other borrowings	4,689	4.80	57	4,689	3.93	47
Total interest bearing liabilities	18,958	4.60	220	17,652	4.09	182
Shareholder's equity/other liabilities	7,141			6,478		
Total liabilities and shareholder's equity	<u>\$26,099</u>			<u>\$24,130</u>		
Net interest income			<u>\$ 388</u>			<u>\$ 354</u>
Net interest margin(1)			6.35%			6.24%
Interest rate spread(2)		5.35%			5.36%	

(1) Net interest margin represents net interest income as a percentage of total interest earning assets.

(2) Interest rate spread represents the difference between the rate on total interest earning assets and the rate on total interest bearing liabilities.

## Average Balance Sheet Analysis.

	Six Months Ended May 31,					
	2006			2005		
	Average Balance	Rate	Interest	Average Balance	Rate	Interest
	(dollars in millions)					
<b>ASSETS</b>						
Interest earning assets:						
General purpose credit card loans	\$20,808	10.41%	\$1,080	\$18,979	9.81%	\$ 929
Other consumer loans	260	7.48	10	403	7.65	15
Investment securities	49	3.86	1	54	1.66	1
Other	4,149	5.00	103	2,920	3.37	49
Total interest earning assets	25,266	9.48	1,194	22,356	8.91	994
Allowance for loan losses	(811)			(893)		
Non-interest earning assets	2,423			2,599		
Total assets	<u>\$26,878</u>			<u>\$24,062</u>		
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>						
Interest bearing liabilities:						
Interest bearing deposits						
Savings	\$ 1,203	4.31%	\$ 26	\$ 651	2.33%	\$ 8
Brokered	11,655	4.50	262	9,382	4.45	208
Other time	1,771	4.45	39	2,742	3.38	46
Total interest bearing deposits	14,629	4.48	327	12,775	4.11	262
Other borrowings	5,338	4.67	124	4,731	3.72	88
Total interest bearing liabilities	19,967	4.53	451	17,506	4.01	350
Shareholder's equity/other liabilities	6,911			6,556		
Total liabilities and shareholder's equity	<u>\$26,878</u>			<u>\$24,062</u>		
Net interest income			<u>\$ 743</u>			<u>\$ 644</u>
Net interest margin(1)			5.90%			5.78%
Interest rate spread(2)		4.95%			4.90%	

(1) Net interest margin represents net interest income as a percentage of total interest earning assets.

(2) Interest rate spread represents the difference between the rate on total interest earning assets and the rate on total interest bearing liabilities.

## Rate/Volume Analysis.

<u>Increase/(Decrease) due to Changes in:</u>	<u>Three Months Ended</u> <u>May 31, 2006 vs. 2005</u>			<u>Six Months Ended</u> <u>May 31, 2006 vs. 2005</u>		
	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>
	(dollars in millions)					
<b>Interest Revenue</b>						
General purpose credit card loans . . . . .	\$ 25	\$ 22	\$47	\$ 91	\$ 60	\$151
Other consumer loans . . . . .	(4)	—	(4)	(5)	—	(5)
Investment securities . . . . .	1	—	1	—	—	—
Other . . . . .	8	20	<u>28</u>	21	33	<u>54</u>
Total interest revenue . . . . .	41	31	<u>72</u>	131	69	<u>200</u>
<b>Interest Expense</b>						
Interest bearing deposits:						
Savings . . . . .	6	8	14	6	12	18
Brokered . . . . .	11	5	16	51	3	54
Other time . . . . .	(6)	4	<u>(2)</u>	(16)	9	<u>(7)</u>
Total interest bearing deposits . . . . .	14	14	<u>28</u>	39	26	<u>65</u>
Other borrowings . . . . .	—	10	<u>10</u>	11	25	<u>36</u>
Total interest expense . . . . .	13	25	<u>38</u>	49	52	<u>101</u>
Net interest income . . . . .	<u>\$ 28</u>	<u>\$ 6</u>	<u>\$34</u>	<u>\$ 82</u>	<u>\$ 17</u>	<u>\$ 99</u>

**Provision for Consumer Loan Losses.** The provision for consumer loan losses decreased 38% and 17% in the quarter and six month period ended May 31, 2006. The decrease in both periods reflected lower net charge-offs primarily related to a decline in bankruptcy filings following the federal bankruptcy legislation that became effective in October 2005 and improved portfolio credit quality resulting in a higher net release of reserves as compared with the prior year periods. The net reduction in reserves was \$21 million and \$118 million in the quarter and six month period ended May 31, 2006, respectively, as compared with \$11 million and \$101 million in the comparable prior year periods, respectively.

**Delinquencies and Charge-offs.** Delinquency rates in both the over 30- and over 90-day categories and net principal charge-off rates were lower for both the owned and managed portfolios, reflecting improvements in portfolio credit quality and the favorable impact following the enactment of federal bankruptcy legislation (see “Managed General Purpose Credit Card Loan Data” herein). While pressure on the consumer continues from higher interest rates, inflation and the increased minimum payment requirements discussed below, there have been no meaningful signs of this pressure in the Company’s U.S. portfolio performance. 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 response to industry-wide regulatory guidance, the Company has increased minimum payment requirements on certain general purpose credit card loans. The Company believes that these increases in minimum payment requirements will negatively impact future levels of general purpose credit card loans and related interest and fee revenue and charge-offs. Bank regulators have discretion to interpret the guidance or its application, and changes in such guidance or its application by the regulators could impact minimum payment requirements.

The Company’s future charge-off rates and credit quality are subject to uncertainties that could cause actual results to differ materially from what has been discussed above. Factors that influence the provision for consumer loan losses include the level and direction of general purpose credit card loan delinquencies and charge-offs, changes in consumer spending and payment behaviors, bankruptcy trends, the seasoning of the Company’s general purpose credit card loan portfolio, interest rate movements and their impact on consumer behavior, and the rate and magnitude of changes in the Company’s general purpose credit card loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio.

**Non-Interest Expenses.** Non-interest expenses increased 4% and 2% in the quarter and six month period ended May 31, 2006. Compensation and benefits expense increased 7% and 10% in the quarter and six month period, primarily reflecting higher incentive-based compensation accruals. The six month period ended May 31, 2006 included Discover's share (\$17 million) of the 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 2% in the quarter and decreased 2% in the six month period. Marketing and business development expenses decreased 8% and 13% in the quarter and six month period due to lower marketing and advertising costs. Professional services expenses increased 26% and 11% in the quarter and six month period primarily due to an increase in legal and consulting fees associated with the acquisition of Goldfish.

**Managed General Purpose Credit Card Loan Data.** The Company analyzes its financial performance on both a "managed" loan basis and as reported under U.S. Generally Accepted Accounting Principles ("U.S. GAAP") ("owned" loan basis). Managed loan data assume that the Company's securitized loan receivables have not been sold and present the results of the securitized loan receivables in the same manner as the Company's owned loans. The Company operates its Discover business and analyzes its financial performance on a managed basis. Accordingly, underwriting and servicing standards are comparable for both owned and securitized loans. The Company believes that managed loan information is useful to investors because it provides information regarding the quality of loan origination and credit performance of the entire managed portfolio and allows investors to understand the related credit risks inherent in owned loans and retained interests in securitizations. In addition, investors often request information on a managed basis, which provides a more meaningful comparison with industry competitors.

The following table provides a reconciliation of owned and managed average loan balances, returns on receivables, interest yields and interest rate spreads for the periods indicated:

**Reconciliation of General Purpose Credit Card Loan Data (dollars in millions)**

	Three Months Ended May 31,							
	2006				2005			
	Average Balance	Return on Receivables(1)	Interest Yield	Interest Rate Spread	Average Balance	Return on Receivables(1)	Interest Yield	Interest Rate Spread
<b>General Purpose</b>								
<b>Credit Card Loans:</b>								
Owned .....	\$19,664	6.83%	11.01%	6.41%	\$18,753	3.48%	10.56%	6.47%
Securitized .....	27,643	4.86%	13.89%	8.76%	28,393	2.30%	12.43%	8.92%
Managed .....	<u>\$47,307</u>	2.84%	12.69%	7.78%	<u>\$47,146</u>	1.38%	11.69%	7.96%

	Six Months Ended May 31,							
	2006				2005			
	Average Balance	Return on Receivables(1)	Interest Yield	Interest Rate Spread	Average Balance	Return on Receivables(1)	Interest Yield	Interest Rate Spread
<b>General Purpose</b>								
<b>Credit Card Loans:</b>								
Owned .....	\$20,808	6.15%	10.41%	5.89%	\$18,979	4.06%	9.81%	5.80%
Securitized .....	26,631	4.80%	13.98%	8.97%	29,049	2.65%	12.53%	9.20%
Managed .....	<u>\$47,439</u>	2.70%	12.42%	7.61%	<u>\$48,028</u>	1.60%	11.46%	7.87%

(1) Return on receivables is equal to Discover annualized income divided by average owned, securitized or managed credit card receivables, as applicable.



## **Other Items.**

### **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.

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).

### **Discontinued Operations.**

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 (see Note 15 to the condensed consolidated financial statements).

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.

### **Business Acquisitions.**

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 (see Note 16 to the condensed consolidated financial statements).

#### **Coleman Litigation.**

In the first quarter of fiscal 2005, the Company recorded a \$360 million charge related to the Coleman litigation matter (See Note 8 to the condensed consolidated financial statements). For further information, refer to “Legal Proceedings” in Part I, Item 3 of the Form 10-K, “Legal Proceedings” in Part II, Item 1 herein, and “Financial Statements and Supplementary Data—Note 9” in Part II, Item 8 of the Form 10-K.

#### **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 was recorded as a reduction to non-interest expenses and is included within 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.

#### **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 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.

#### **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.

### **Accounting Developments.**

#### *Limited Partnerships.*

In June 2005, the Financial Accounting Standards Board ("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.

#### *Accounting for Certain Hybrid Financial Instruments.*

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments," which amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." 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. For the Company, 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.

#### *Accounting for Servicing of Financial Assets.*

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.

*Determining the Variability in Variable Interest Entities.*

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 FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities" ("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.

**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.

## **Critical Accounting Policies.**

The condensed consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the Company to make estimates and assumptions (see Note 1 to the condensed consolidated financial statements). The Company believes that of its accounting policies (see Note 2 to the consolidated financial statements for the fiscal year ended November 30, 2005 included in the Form 10-K), the following involve a higher degree of judgment and complexity.

### **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 in Principal trading and investment revenues in the condensed consolidated statements of income. 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. Even in normally active markets, the price transparency for actively quoted instruments may be reduced for periods of time during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market-makers willing to purchase and sell a product provides a source of transparency for products that otherwise are not actively quoted or during periods of market dislocation.

The Company's cash products include securities issued by the U.S. government and its agencies, other sovereign debt obligations, corporate and other debt securities, corporate equity securities, exchange traded funds and physical commodities. The fair value of these products is based principally on observable market prices or is derived using observable market parameters. These products generally do not entail a significant degree of judgment in determining fair value. Examples of 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 include securities issued by the U.S. government and its agencies, exchange traded corporate equity securities, most municipal debt securities, most corporate debt securities, most high-yield debt securities, physical commodities, certain tradable loan products and most mortgage-backed securities.

In certain circumstances, principally involving loan products and other financial instruments held for securitization transactions, the Company determines fair value from within the range of bid and ask prices such that fair value indicates the value likely to be realized in a current market transaction. Bid prices reflect the price that the Company and others pay, or stand ready to pay, to originators of such assets. Ask prices represent the prices that the Company and others require to sell such assets to the entities that acquire the financial instruments for purposes of completing the securitization transactions. Generally, the fair value of such acquired assets is based upon the bid price in the market for the instrument or similar instruments. In general, the loans and similar assets are valued at bid pricing levels until structuring of the related securitization is substantially complete and such that the value likely to be realized in a current transaction is consistent with the price that a securitization entity will pay to acquire the financial instruments. Factors affecting securitized value and investor demand relating specifically to loan products include, but are not limited to, loan type, underlying property type and geographic location, loan interest rate, loan to value ratios, debt service coverage ratio, investor demand and credit enhancement levels.

In addition, some cash products exhibit little or no price transparency, and the determination of fair value requires more judgment. Examples of cash products with little or no price transparency include certain high-yield debt, certain collateralized mortgage obligations, certain tradable loan products, distressed debt securities (i.e., securities of issuers encountering financial difficulties, including bankruptcy or insolvency) and equity securities that are not publicly traded. Generally, the fair value of these types of cash products is determined using one of several valuation techniques appropriate for the product, which can include cash flow analysis, revenue or net income analysis, default recovery analysis (i.e., analysis of the likelihood of default and the potential for recovery) and other analyses applied consistently.

The following table presents the valuation of the Company's cash products included within Financial instruments owned and Financial instruments sold, not yet purchased by level of price transparency (dollars in millions):

	At May 31, 2006		At November 30, 2005	
	Assets	Liabilities	Assets	Liabilities
Observable market prices, parameters or derived from observable prices or parameters .....	\$238,640	\$110,669	\$203,590	\$101,972
Reduced or no price transparency .....	19,995	406	11,131	76
Total .....	\$258,635	\$111,075	\$214,721	\$102,048

The Company's derivative products include exchange traded and OTC derivatives. Exchange traded derivatives have valuation attributes similar to the cash products valued using observable market prices or market parameters described above. OTC derivatives, whose fair value is derived using pricing models, include a wide variety of instruments, such as interest rate swap and option contracts, foreign currency option contracts, credit and equity swap and option contracts, and commodity swap and option contracts.

The following table presents the fair value of the Company's exchange traded and OTC derivatives included within Financial instruments owned and Financial instruments sold, not yet purchased (dollars in millions):

	At May 31, 2006		At November 30, 2005	
	Assets	Liabilities	Assets	Liabilities
Exchange traded .....	\$ 6,715	\$10,213	\$ 4,491	\$ 8,151
OTC .....	44,821	38,534	41,403	36,801
Total .....	\$51,536	\$48,747	\$45,894	\$44,952

The fair value of 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 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.

Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swap and option contracts. A substantial majority of OTC derivative products valued by the Company using pricing models fall into this category. Other derivative products, typically the newest and most complex products, will require more judgment in the implementation of the modeling technique applied due to the complexity of the modeling assumptions and the reduced price transparency surrounding the model's market parameters. The Company manages its market exposure for OTC derivative products primarily by entering into offsetting derivative contracts or other related financial instruments. The Company's trading divisions, the Financial Control Department and the Market Risk Department continuously monitor the price changes of the OTC derivatives in relation to the offsetting positions. For a further discussion of the price transparency of the Company's OTC derivative products, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management—Credit Risk" in Part II, Item 7A of the Form 10-K.

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.

The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable market prices or market-based parameters wherever possible. In the event that market prices or parameters are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks. Additionally, groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model. Consistent with market practice, the Company has individually negotiated agreements with certain counterparties to exchange collateral ("margining") based on the level of fair values of the derivative contracts they have executed. Through this margining process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional support of the Company's recorded fair value for the relevant OTC derivative products. For certain OTC derivative products, the Company, along with other market participants, contributes derivative pricing information to aggregation services that synthesize the data and make it accessible to subscribers. This

information is then used to evaluate the fair value of these OTC derivative products. For more information regarding the Company's risk management practices, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management" in Part II, Item 7A of the Form 10-K.

#### **Allowance for Consumer Loan Losses.**

The allowance for consumer loan losses in the Company's Discover business is established through a charge to the provision for consumer loan losses. Provisions are made to reserve for estimated losses in outstanding loan balances. The allowance for consumer loan losses is a significant estimate that represents management's estimate of probable losses inherent in the consumer loan portfolio. The allowance for consumer loan losses is primarily applicable to the owned homogeneous consumer credit card loan portfolio and is evaluated quarterly for adequacy.

In calculating the allowance for consumer loan losses, the Company uses a systematic and consistently applied approach. This process starts with a migration analysis (a technique used to estimate the likelihood that a consumer loan will progress through the various stages of delinquency and ultimately charge off) of delinquent and current consumer credit card accounts in order to determine the appropriate level of the allowance for consumer loan losses. The migration analysis considers uncollectible principal, interest and fees reflected in consumer loans. In evaluating the adequacy of the allowance for consumer loan losses, management also considers factors that may impact future credit loss experience, including current economic conditions, recent trends in delinquencies and bankruptcy filings, account collection management, policy changes, account seasoning, loan volume and amounts, payment rates and forecasting uncertainties. A provision for consumer loan losses is charged against earnings to maintain the allowance for consumer loan losses at an appropriate level. The use of different estimates or assumptions could produce different provisions for consumer loan losses (see "Discover—Provision for Consumer Loan Losses" herein).

#### **Legal, Regulatory and Tax Contingencies.**

In the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or in financial distress. The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company's business, including, among other matters, accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief. The number of these reviews, investigations and proceedings has increased in recent years with regard to many firms in the financial services industry, including the Company.

Reserves for litigation and regulatory proceedings are generally determined on a case-by-case basis and represent an estimate of probable losses after considering, among other factors, the progress of each case, prior experience and the experience of others in similar cases, and the opinions and views of internal and external legal counsel. 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.

The Company is subject to the income tax laws of the U.S., its states and municipalities and those of the foreign jurisdictions in which the Company has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. The Company must

make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and must also make estimates about when in the future certain items affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Company regularly assesses the likelihood of assessments in each of the taxing jurisdictions resulting from current and subsequent years' examinations, and tax reserves are established as appropriate.

The Company establishes reserves for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated in accordance with SFAS No. 5, "Accounting for Contingencies." Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change. Significant judgment is required in making these estimates, and the actual cost of a legal claim, tax assessment or regulatory fine/penalty may ultimately be materially different from the recorded reserves, if any.

See Notes 8 and 17 to the condensed consolidated financial statements for additional information on legal proceedings and income tax examinations.

## **Liquidity and Capital Resources.**

The Company's senior management establishes the overall liquidity and capital policies of the Company. Through various risk and control committees, the Company's senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity and interest rate and currency sensitivity of the Company's asset and liability position. These committees, along with the Company's Treasury Department and other control groups, also assist in evaluating, monitoring and controlling the impact that the Company's business activities have on its condensed consolidated balance sheet, liquidity and capital structure, thereby helping to ensure that its business activities are integrated with the Company's liquidity and capital policies.

The Company's liquidity and funding risk management policies are designed to mitigate the potential risk that the Company may be unable to access adequate financing to service its financial obligations when they come due without material, adverse franchise or business impact. The key objectives of the liquidity and funding risk management framework are to support the successful execution of the Company's business strategies while ensuring ongoing and sufficient liquidity through the business cycle and during periods of financial distress. The principal elements of the Company's liquidity framework are the cash capital policy, the liquidity reserve and stress testing through the contingency funding plan. Comprehensive financing guidelines (collateralized funding, long-term funding strategy, surplus capacity, diversification, staggered maturities and committed credit facilities) support the Company's target liquidity profile.

For a more detailed summary of the Company's Liquidity and Capital Policies and funding sources, including committed credit facilities and off-balance sheet funding, refer to "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources" in Part II, Item 7 of the Form 10-K.

### **The Balance Sheet.**

The Company monitors and evaluates the composition and size of its balance sheet. Given the nature of the Company's market-making and customer financing activities, the overall size of the balance sheet fluctuates from time to time. A substantial portion of the Company's total assets consists of highly liquid marketable securities and short-term receivables arising principally from its Institutional Securities sales and trading activities. The highly liquid nature of these assets provides the Company with flexibility in financing and managing its business.

The Company's total assets increased to \$1,027.0 billion at May 31, 2006 from \$898.5 billion at November 30, 2005. The increase was primarily due to increases in financial instruments owned (largely driven by increases in corporate and other debt and corporate equities), receivables from customers, securities borrowed and securities received as collateral. The increase was also due to an increase in securities purchased under agreements to resell, partially offset by a decrease in cash and cash equivalents. The increases were largely the result of higher market volatility globally and an increase in client business opportunities.

Balance sheet leverage ratios are one indicator of capital adequacy when viewed in the context of a company's overall liquidity and capital policies. The Company views the adjusted leverage ratio as a more relevant measure of financial risk when comparing financial services firms and evaluating leverage trends. The Company has adopted a definition of adjusted assets that excludes certain self-funded assets considered to have minimal market, credit and/or liquidity risk. These low-risk assets generally are attributable to the Company's matched book and securities lending businesses. Adjusted assets are calculated by reducing gross assets by aggregate resale agreements and securities borrowed less non-derivative short positions and assets recorded under certain provisions of SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities—a replacement of FASB Statement No. 125," and FIN 46R. The adjusted leverage ratio reflects the deduction from shareholders' equity of the amount of equity used to support goodwill and intangible assets (as the Company does not view this amount of equity as available to support its risk capital needs). In addition, the Company views junior subordinated debt issued to capital trusts as a component of its capital base given the

inherent characteristics of the securities. These characteristics include the long-dated nature (e.g., some have final maturity at issuance of 30 years extendible at the Company's option by a further 19 years, others have a 40 year final maturity at issuance), the Company's ability to defer coupon interest for up to 20 consecutive quarters and the subordinated nature of the obligations in the capital structure. The Company also receives rating agency equity credit for these securities.

The following table sets forth the Company's total assets, adjusted assets and leverage ratios as of May 31, 2006 and November 30, 2005 and for the average month-end balances during the quarter and six month period ended May 31, 2006:

	Balance at		Average Month-End Balance	
	May 31, 2006	November 30, 2005	For the Quarter Ended May 31, 2006	For the Six Month Period Ended May 31, 2006
	(dollars in millions, except ratio data)			
Total assets	\$1,027,043	\$ 898,523	\$1,002,868	\$ 977,807
Less: Securities purchased under agreements to resell	(190,289)	(174,330)	(184,035)	(185,924)
Securities borrowed	(274,581)	(244,241)	(265,446)	(260,558)
Add: Financial instruments sold, not yet purchased	159,822	147,000	155,342	151,227
Less: Derivative contracts sold, not yet purchased	(48,747)	(44,952)	(46,366)	(45,474)
Subtotal	673,248	582,000	662,363	637,078
Less: Segregated customer cash and securities balances	(31,685)	(30,540)	(28,195)	(28,889)
Assets recorded under certain provisions of SFAS No. 140 and FIN 46R	(90,046)	(67,091)	(83,284)	(77,800)
Goodwill and net intangible assets	(2,932)	(2,500)	(2,899)	(2,731)
Adjusted assets	\$ 548,585	\$ 481,869	\$ 547,985	\$ 527,658
Shareholders' equity	\$ 32,255	\$ 29,182	\$ 31,182	\$ 30,412
Junior subordinated debt issued to capital trusts	3,473	2,764	3,538	3,336
Subtotal	35,728	31,946	34,720	33,748
Less: Goodwill and net intangible assets	(2,932)	(2,500)	(2,898)	(2,731)
Tangible shareholders' equity	\$ 32,796	\$ 29,446	\$ 31,822	\$ 31,017
Leverage ratio(1)	31.3x	30.5 x	31.5x	31.5x
Adjusted leverage ratio(2)	16.7x	16.4 x	17.2x	17.0x

(1) Leverage ratio equals total assets divided by tangible shareholders' equity.

(2) Adjusted leverage ratio equals adjusted assets divided by tangible shareholders' equity.

### Activity in the Six Month Period Ended May 31, 2006.

The Company's total capital consists of shareholders' equity, long-term borrowings (debt obligations scheduled to mature in more than 12 months), junior subordinated debt issued to capital trusts, and Capital Units. At May 31, 2006, total capital was \$145.7 billion, an increase of \$19.8 billion from November 30, 2005.

During the six month period ended May 31, 2006, the Company issued senior notes aggregating \$26.5 billion, including non-U.S. dollar currency notes aggregating \$11.5 billion and \$889 million of junior subordinated debentures. At May 31, 2006, the aggregate outstanding principal amount of the Company's Senior Indebtedness (as defined in the Company's debt indentures) was approximately \$149 billion (including guaranteed obligations of the indebtedness of subsidiaries). The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately five years at May 31, 2006.

During the six month period ended May 31, 2006, the Company purchased approximately \$1,312 million of its common stock (approximately 22 million shares) through open market purchases at an average cost of \$59.47 (see also “Unregistered Sales of Equity Securities and Use of Proceeds” in Part II, Item 2). During fiscal 2006, the Company currently anticipates that repurchases of its common stock pursuant to its equity antidilution program will be approximately \$2 billion or less.

Subsequent to quarter-end, on July 6, 2006, the Company issued \$1 billion of Floating Rate Non-Cumulative Preferred Stock, Series A.

### **Economic Capital.**

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. The Company calculates economic capital on a going concern basis, which 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. Business unit economic capital allocations are evaluated by benchmarking to similarly rated peer firms by business segment. The Company believes this methodology provides an indication of the appropriate level of capital for each business segment as if each were an independent operating entity.

Economic capital requirements are allocated to each business segment and are sub-allocated to product lines as appropriate. This process is intended to align equity capital with the risks in each business, provide business managers with tools for measuring and managing risk, and allow senior management to evaluate risk-adjusted returns (such as return on economic capital and shareholder value added) to facilitate resource allocation decisions.

The Company’s methodology is based on an approach that assigns economic capital to each business unit based on regulatory capital usage plus additional capital for stress losses. Regulatory capital, including additional capital assigned for goodwill, intangible assets and principal investment risk, is a minimum requirement to ensure funding access and customer credibility. The Company believes it must be able to sustain stress losses and maintain capital substantially above regulatory minimums while supporting ongoing business activities. Aggregate economic capital requirements represent the minimum amount of book equity capital required under the going concern approach. The difference between the Company’s consolidated common equity and aggregate economic capital denotes the Company’s unallocated capital position, which is not currently allocated to the business segments or reflected in business segment performance metrics.

The Company assesses stress loss capital across various dimensions of market, credit, business and operational risks. Stress losses are defined at the 90% to 95% confidence interval in order to capture worst potential losses in 10 to 20 years. Stress loss calculations are tangible and transparent and avoid reliance on extreme loss statistical models.

Market risk scenarios capture systematic, idiosyncratic and random market risk through the use of internal market stress data. Credit risk is included in the form of idiosyncratic counterparty default events. Business risk incorporates earnings volatility due to variability in revenue flows, with estimates on the mix of fixed versus variable expenses at various points in the business cycle. Operational stress losses primarily reflect legal risk across the Company.

The Company may enhance the economic capital model and allocation methodology over time in response to changes in the business and regulatory environment to ensure that the model continues to reflect the risks inherent in the Company’s business activities and to reflect changes in the drivers of the level and cost of required capital.

The following table presents the Company's allocated average common equity (economic capital) during the quarters and six month periods ended May 31, 2006 and 2005:

	Three Months Ended May 31,		Six Months Ended May 31,	
	2006	2005	2006	2005
<b>Average common equity (dollars in billions):</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
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
Consolidated .....	<u>\$31.2</u>	<u>\$28.4</u>	<u>\$30.4</u>	<u>\$28.4</u>

### Liquidity Management Policies.

The primary goal of the Company's liquidity and funding activities is to ensure adequate financing over a wide range of potential credit ratings and market environments. Given the highly liquid nature of the Company's balance sheet, day-to-day funding requirements are largely fulfilled through the use of stable collateralized financing. The Company has centralized management of credit-sensitive unsecured funding sources in the Treasury Department. In order to meet target liquidity requirements and withstand an unforeseen contraction in credit availability, the Company has designed a liquidity management framework.

Liquidity Management Framework:	Designed to:
Contingency Funding Plan	Ascertain the Company's ability to manage a prolonged liquidity contraction and provide a course of action over a one-year time period to ensure orderly functioning of the businesses. The contingency funding plan sets forth the process and the internal and external communication flows necessary to ensure effective management of the contingency event. Analytical processes exist to periodically evaluate and report the liquidity risk exposures of the organization under management-defined scenarios.
Cash Capital	Ensure that the Company can fund its balance sheet while repaying its financial obligations maturing within one year without issuing new unsecured debt. The Company attempts to achieve this by maintaining sufficient cash capital (long-term debt and equity capital) to finance illiquid assets and the portion of its securities inventory that is not expected to be financed on a secured basis in a credit-stressed environment.
Liquidity Reserve	Maintain, at all times, a liquidity reserve composed of immediately available cash and cash equivalents and a pool of unencumbered securities that can be sold or pledged to provide same-day liquidity to the Company. The reserve is periodically assessed and determined based on day-to-day funding requirements and strategic liquidity targets. The liquidity reserve averaged approximately \$42 billion for the six month period ended May 31, 2006, of which approximately \$36 billion on average was held at the parent company.

### **Liquidity Reserve.**

The Company seeks to maintain a target liquidity reserve that is sized to cover daily funding needs and to meet strategic liquidity targets, including coverage of a significant portion of expected cash outflows over a short-term horizon in a potential liquidity crisis. This liquidity reserve is held in the form of cash deposits with banks and a pool of unencumbered securities. The Company manages the pool of unencumbered securities, against which funding can be raised, on a global basis, and securities for the pool are chosen accordingly. The U.S. and non-U.S. components, held in the form of a reverse repurchase agreement at the parent company, consist primarily of U.S. and European government bonds and other high quality collateral and at May 31, 2006 were approximately \$28 billion and averaged approximately \$23 billion during the six month period ended May 31, 2006. The parent company cash component of the liquidity reserve at May 31, 2006 was approximately \$5 billion and averaged approximately \$13 billion for the six month period ended May 31, 2006. The Company believes that diversifying the form in which its liquidity reserve (cash and securities) is maintained enhances its ability to quickly and efficiently source funding in a stressed environment. The Company's funding requirements and target liquidity reserve may vary based on changes in the level and composition of its balance sheet, timing of specific transactions, client financing activity, market conditions and seasonal factors.

### **Committed Credit Facilities.**

The maintenance of committed credit facilities serves to further diversify the Company's funding sources. The Company values committed credit as a secondary component of its liquidity management framework. The committed credit facilities include a diversification of lenders to the Company covering geographic regions, including North America, Europe and Asia.

During the quarter ended May 31, 2006, the Company restructured the Morgan Stanley and Morgan Stanley Japan Securities Co., Ltd. ("MSJS", as successor to the business of Morgan Stanley Japan Limited) Committed Revolving Credit Facility (the "MS-MSJS Facility"). The MS-MSJS Facility consists of three separate tranches: a U.S. dollar tranche with the Company as borrower; a Japanese yen tranche with MSJS as borrower and the Company as borrower and guarantor for MSJS borrowings; and a multicurrency tranche available in both euro and sterling with the Company as borrower. Under the MS-MSJS Facility, a group of banks is committed to provide up to \$7.5 billion under the U.S. dollar tranche; 80 billion Japanese yen under the Japanese yen tranche and \$3.25 billion under the multicurrency tranche. Concurrent with these changes, the Company terminated Morgan Stanley & Co. Incorporated's \$1.8 billion secured committed credit facility and Morgan Stanley & Co. International Limited's \$1.5 billion committed revolving credit facility. At May 31, 2006, the Company had a \$13.3 billion consolidated stockholders' equity surplus as compared with the MS-MSJS Facility's covenant requirement.

The Company anticipates that it may utilize the MS-MSJS Facility for short-term funding from time to time. The Company does not believe that any of the covenant requirements in the MS-MSJS Facility will impair its ability to obtain funding under the MS-MSJS Facility, to pay its current level of dividends, or to obtain loan arrangements, letters of credit or other financial accommodations. At May 31, 2006, no borrowings were outstanding under the MS-MSJS Facility.

### **Credit Ratings.**

The Company's reliance on external sources to finance a significant portion of its day-to-day operations makes access to global sources of financing important. The cost and availability of unsecured financing generally are dependent on the Company's short-term and long-term credit ratings. Factors that are significant to the determination of the Company's credit ratings or that otherwise affect its ability to raise short-term and long-term financing include the Company's level and volatility of earnings, relative positions in the markets in which it operates, geographic and product diversification, retention of key personnel, risk management policies, cash liquidity, capital structure, corporate lending credit risk, and legal and regulatory developments. In addition, continuing consolidation in the credit card industry presents Discover with stronger competitors that may

challenge future growth. A deterioration in any of the previously mentioned factors or combination of these factors may lead rating agencies to downgrade the credit ratings of the Company, thereby increasing the cost to the Company in obtaining unsecured funding. In addition, the Company's debt ratings can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as OTC derivative transactions, including credit derivatives and interest rate swaps.

In connection with certain OTC trading agreements and certain other agreements associated with the Institutional Securities business, the Company would be required to provide additional collateral to certain counterparties in the event of a downgrade by either Moody's Investors Service or Standard & Poor's. At May 31, 2006, the amount of additional collateral that would be required in the event of a one-notch downgrade of the Company's senior debt credit rating was approximately \$1,369 million. Of this amount, \$474 million relates to bilateral arrangements between the Company and other parties where upon the downgrade of one party, the downgraded party must deliver incremental collateral to the other. These bilateral downgrade arrangements are a risk management tool used extensively by the Company as credit exposures are reduced if counterparties are downgraded.

As of June 30, 2006, the Company's credit ratings were as follows:

	<u>Commercial Paper</u>	<u>Senior Debt</u>
Dominion Bond Rating Service Limited .....	R-1 (middle)	AA (low)
Fitch Ratings .....	F1+	AA-
Moody's Investors Service .....	P-1	Aa3
Rating and Investment Information, Inc. ....	a-1+	AA
Standard & Poor's .....	A-1	A+

### Commitments.

The Company's commitments associated with outstanding letters of credit, investment activities, and corporate lending and financing commitments as of May 31, 2006 are summarized below by period of expiration. Since commitments associated with letters of credit and lending and financing arrangements may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	<u>Years to Maturity</u>				<u>Total</u>
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>	
	(dollars in millions)				
Letters of credit(1) .....	\$ 7,579	\$ 6	\$ —	\$ —	\$ 7,585
Investment activities .....	88	82	9	317	496
Investment grade corporate lending commitments(2) .....	4,764	5,132	14,636	2,556	27,088
Non-investment grade lending corporate commitments(2) ....	2,903	896	2,037	2,353	8,189
Commitments for secured lending transactions(3) .....	10,256	3,145	92	100	13,593
Commitments to purchase mortgage loans(4) .....	8,550	—	—	—	8,550
Total(5) .....	<u>\$34,140</u>	<u>\$9,261</u>	<u>\$16,774</u>	<u>\$5,326</u>	<u>\$65,501</u>

- (1) This amount represents the Company's outstanding letters of credit, which are primarily used to satisfy various collateral requirements.
- (2) The Company's investment grade and non-investment grade lending commitments are made in connection with its corporate lending activities. Credit ratings are determined by the Company's Institutional Credit Department using methodologies generally consistent with those employed by external rating agencies. Credit ratings of BB+ or lower are considered non-investment grade.
- (3) This amount represents lending commitments extended by the Company to companies that are secured by assets of the borrower. Loans made under these arrangements typically are at variable rates and generally provide for over-collateralization based upon the creditworthiness of the borrower.
- (4) This amount represents the Company's forward purchase contracts involving mortgage loans.
- (5) See Note 8 to the condensed consolidated financial statements.

The table above does not include 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 (see Note 4 to the condensed consolidated financial statements). In addition, in the ordinary course of business, the Company guarantees the debt and/or certain trading obligations (including obligations associated with derivatives, foreign exchange contracts and the settlement of physical commodities) of certain subsidiaries. These guarantees generally are entity or product specific and are required by investors or trading counterparties. The activities of the subsidiaries covered by these guarantees (including any related debt or trading obligations) are included in the Company's condensed consolidated financial statements.

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

### Investments.

The table below includes investments made by the Company that represent business facilitation or principal investing activities at May 31, 2006 and November 30, 2005 and are included within Other assets on the condensed consolidated statement of financial condition. Business facilitation investments are strategic investments undertaken by the Company to facilitate core business activities. Principal investing activities are capital investments in private companies, generally for proprietary purposes, to maximize total returns to the Company. The Company has committed to increasing its principal investing activity. The Company intends to make additional investments over time to bring the level of principal investments to approximately \$2.5 billion.

	At May 31, 2006				
	Institutional Securities	Global Wealth Management Group	Asset Management	Discover	Total
	(dollars in millions)				
Business facilitation:					
Private equity funds . . . . .	\$ 26	\$—	\$200	\$—	\$ 226
Real estate funds . . . . .	378	—	—	—	378
Asset management seed capital . . . . .	—	—	446	—	446
Industry utilities(1) . . . . .	545	7	—	—	552
Other . . . . .	186	38	12	10	246
Total business facilitation . . . . .	<u>1,135</u>	<u>45</u>	<u>658</u>	<u>10</u>	<u>1,848</u>
Principal investments(2) . . . . .	<u>1,225</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>1,225</u>
Total investments . . . . .	<u>\$2,360</u>	<u>\$ 45</u>	<u>\$658</u>	<u>\$ 10</u>	<u>\$3,073</u>

At November 30, 2005(3)

	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Discover</u>	<u>Total</u>
	(dollars in millions)				
Business facilitation:					
Private equity funds .....	\$ 14	\$—	\$185	\$—	\$ 199
Real estate funds .....	359	—	—	—	359
Asset management seed capital .....	—	—	236	—	236
Industry utilities(1) .....	371	—	—	—	371
Other .....	182	37	12	9	240
Total business facilitation .....	926	37	433	9	1,405
Principal investments .....	1,195	—	—	—	1,195
Total investments .....	<u>\$2,121</u>	<u>\$ 37</u>	<u>\$433</u>	<u>\$ 9</u>	<u>\$2,600</u>

- (1) Any investment made to participate in an industry consortium or an industry service with the intention to support core business activities and advance business growth.
- (2) Investment, dividend and net interest revenues associated with principal investments was \$239 million and \$273 million for the quarter and six month period ended May 31, 2006, respectively.
- (3) Certain reclassifications have been made to prior-period amounts to conform to the current period's presentation.

### Regulatory Requirements.

Effective December 1, 2005, the Company became a consolidated supervised entity ("CSE") as defined by the Securities and Exchange Commission ("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.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk.

#### Market Risk.

The Company uses 99%/One-Day Value-at-Risk (“VaR”) as one of a range of risk management tools. VaR values should be interpreted in light of the method’s strengths and limitations. A small proportion of risk generated by trading positions is not included in VaR, and the modeling of the risk characteristics of some positions relies upon approximations that, under certain circumstances, could produce significantly different VaR results from those produced using more precise measures. For a further discussion of the Company’s VaR methodology and its limitations, and the Company’s risk management policies and control structure, see “Quantitative and Qualitative Disclosures about Market Risk—Risk Management” in Part II, Item 7A of the Form 10-K.

The tables below present the following: the Company’s quarter-end Aggregate (Trading and Non-trading), Trading, and Non-trading VaR (see Table 1 below); the Company’s quarterly average, high, and low Trading VaR (see Table 2 below); and the VaR statistics that would result if the Company were to adopt alternative parameters for its VaR calculations, such as the reported confidence level (99% vs. 95%) for the VaR statistic or a shorter historical time series (four years vs. one year) of market data upon which it bases its simulations (see Table 3 below). Aggregate trading and non-trading VaR incorporates certain non-trading positions which are not included in Trading VaR; these include (a) the funding liabilities related to institutional trading positions and (b) public-company equity positions recorded as investments by the Company. Investments made by the Company that are not publicly traded are not reflected in the VaR results below. As of May 31, 2006, the aggregate carrying value of such investments was approximately \$2.3 billion.

The table below presents VaR for each of the Company’s primary risk exposures and on an aggregate basis at May 31, 2006, February 28, 2006 and November 30, 2005:

Table 1: 99% Total VaR	Aggregate (Trading and Non-trading)			Trading			Non-trading		
	99%/One-Day VaR at			99%/One-Day VaR at			99%/One-Day VaR at		
	May 31, 2006	February 28, 2006	November 30, 2005	May 31, 2006	February 28, 2006	November 30, 2005	May 31, 2006	February 28, 2006	November 30, 2005
	(dollars in millions)								
Interest rate and credit spread . . . .	\$ 57	\$ 79	\$ 56	\$ 54	\$ 70	\$ 51	\$18	\$28	\$35
Equity price . . . . .	47	49	41	40	43	36	23	20	10
Foreign exchange rate . . . . .	12	15	10	12	15	10	—	—	—
Commodity price . . . . .	47	42	50	47	42	50	—	—	—
Subtotal . . . . .	163	185	157	153	170	147	41	48	45
Less diversification benefit(1) . . . . .	75	70	64	70	65	65	12	14	7
Total VaR . . . . .	<u>\$ 88</u>	<u>\$115</u>	<u>\$ 93</u>	<u>\$ 83</u>	<u>\$105</u>	<u>\$ 82</u>	<u>\$29</u>	<u>\$34</u>	<u>\$38</u>

(1) Diversification benefit equals the difference between Total VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories occur on different days; similar diversification benefits also are taken into account within each category.

The Company’s Aggregate VaR and Trading VaR at May 31, 2006 were \$88 million and \$83 million, respectively, compared with \$115 million and \$105 million, respectively, at February 28, 2006. At the end of the quarter ended May 31, 2006, in response to increased realized market volatility, the Company reduced its risk exposure, as measured by VaR, to a level below that which was maintained earlier in the quarter. As a result, quarter-end VaR was significantly below average Trading VaR during the quarter. The Company will continue to monitor and adjust its risk profile in consideration of future market conditions.

The Company views average Trading VaR as more representative of trends in the business over a period than VaR at any single point in time. Table 2 below, which presents the high, low and average 99%/one-day Trading VaR during the quarters ended May 31, 2006, February 28, 2006 and November 30, 2005, represents substantially all of the Company's trading activities. Certain market risks included in the Aggregate VaR discussed above are excluded from these measures (e.g., equity price risk in public company equity positions recorded as investments by the Company and certain funding liabilities related to trading positions).

Average Trading VaR for the quarter ended May 31, 2006 increased to \$96 million from \$84 million for the quarter ended February 28, 2006, reflecting increases in interest rate and credit spread VaR and equity price VaR. The increase in interest rate and credit spread VaR was driven primarily by increased exposure to credit-sensitive fixed income instruments. The increase in equity price VaR was predominantly driven by increased directional exposure to equity products.

**Table 2: 99% High/Low/Average Trading VaR**

Primary Market Risk Category	Daily 99%/One-Day VaR for the Quarter Ended May 31, 2006			Daily 99%/One-Day VaR for the Quarter Ended February 28, 2006			Daily 99%/One-Day VaR for the Quarter Ended November 30, 2005		
	High	Low	Average	High	Low	Average	High	Low	Average
	(dollars in millions)								
Interest rate and credit spread . . . . .	\$ 82	\$52	\$66	\$ 70	\$46	\$53	\$60	\$47	\$53
Equity price . . . . .	57	37	43	48	30	36	41	28	34
Foreign exchange rate . . . . .	20	8	12	22	9	14	16	10	12
Commodity price . . . . .	52	36	44	56	41	49	53	39	46
Trading VaR . . . . .	\$120	\$83	\$96	\$105	\$73	\$84	\$93	\$72	\$81

***VaR Statistics for Comparisons with Other Global Financial Services Firms.***

VaR statistics are not readily comparable across firms because of differences in the breadth of products included in the VaR model, in the statistical assumptions made when simulating changes in market factors, and in the methods used to approximate portfolio revaluations under the simulated market conditions. These differences can result in materially different VaR estimates for similar portfolios. As a result, VaR statistics are more reliable and relevant when used as indicators of trends in risk taking within a firm rather than as a basis for inferring differences in risk taking across firms. Table 3 below presents the VaR statistics that would result if the Company were to adopt alternative parameters for its calculations, such as the reported confidence level (99% versus 95%) for the VaR statistic or a shorter historical time series (four years versus one year), for market data upon which it bases its simulations:

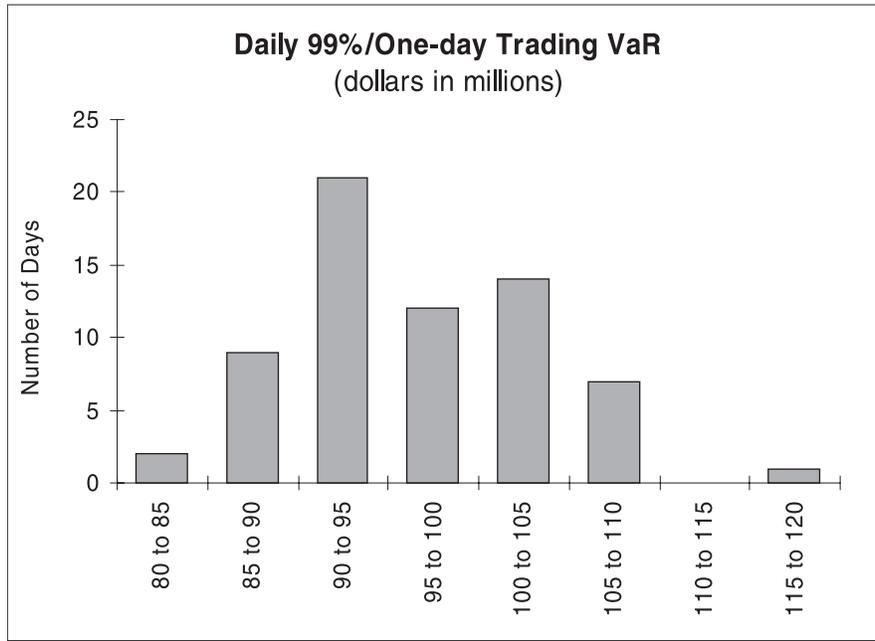
**Table 3: Average 99% and 95% Trading VaR with Four-Year/One-Year Historical Time Series**

Primary Market Risk Category	Average 99%/One-Day VaR for the Quarter Ended May 31, 2006		Average 95%/One-Day VaR for the Quarter Ended May 31, 2006	
	Four-Year Factor History	One-Year Factor History	Four-Year Factor History	One-Year Factor History
	(dollars in millions)			
Interest rate and credit spread . . . . .	\$66	\$48	\$39	\$32
Equity price . . . . .	43	39	29	27
Foreign exchange rate . . . . .	12	12	9	8
Commodity price . . . . .	44	64	28	32
Trading VaR . . . . .	\$96	\$88	\$63	\$58

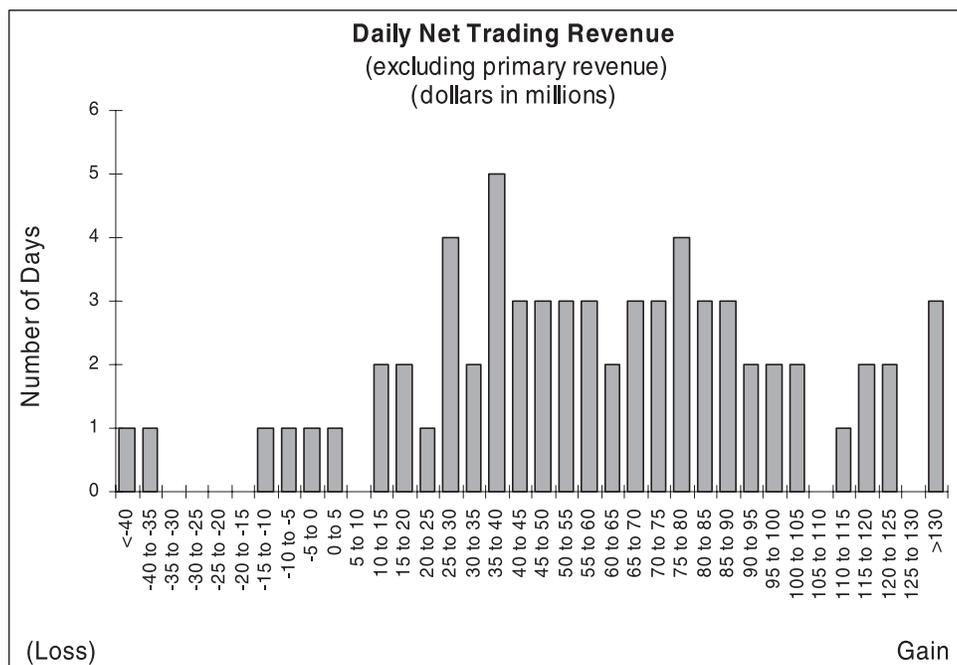
In addition, if the Company were to report Trading VaR (using a four-year historical time series) with respect to a 10-day holding period, the Company's 99% and 95% Average Trading VaR for the quarter ended May 31, 2006 would have been \$305 million and \$200 million, respectively.

***Distribution of VaR Statistics and Net Revenues for the quarter ended May 31, 2006.***

As shown in Table 2 above, the Company's average 99%/one-day Trading VaR for the quarter ended May 31, 2006 was \$96 million. The histogram below presents the distribution of the Company's daily 99%/one-day Trading VaR for the quarter ended May 31, 2006. The most frequently occurring value was between \$90 million and \$95 million.



One method of evaluating the reasonableness of the Company's VaR model as a measure of the Company's potential volatility of net revenue is to compare the VaR with actual trading revenue. Assuming no intra-day trading, for a 99%/one-day VaR, the expected number of times that trading losses should exceed VaR during the fiscal year is three, and, in general, if trading losses were to exceed VaR more than five times in a year, the accuracy of the VaR model could be questioned. Accordingly, the Company evaluates the reasonableness of its VaR model by comparing the potential declines in portfolio values generated by the model with actual trading results. The histogram below shows the distribution of daily net revenue during the quarter ended May 31, 2006 for the Company's trading businesses (including net interest and commissions but excluding primary and prime brokerage revenue credited to the trading businesses). There were no days during the quarter ended May 31, 2006 in which the Company incurred daily trading losses in excess of the 99%/one-day Trading VaR for that given day. Additionally, there were no days during the quarter where the largest one-day loss exceeded the lowest 99%/one-day Trading VaR.



As of May 31, 2006, interest rate risk exposure associated with the Company's consumer lending activities, included within Discover, as measured by the reduction in pre-tax income resulting from a hypothetical, immediate 100 basis point increase in interest rates, had not changed significantly from November 30, 2005.

## Credit Risk.

For a further discussion of the Company's credit risks, see "Quantitative and Qualitative Disclosures about Market Risks—Credit Risk" in Part II, Item 7A of the Form 10-K.

**Credit Exposure-Corporate Lending.** At May 31, 2006 and November 30, 2005, the aggregate value of investment grade loans and financial accommodations was \$6.2 billion and \$5.0 billion, respectively, and the aggregate value of non-investment grade loans and positions was \$2.9 billion and \$2.3 billion, respectively. At May 31, 2006 and November 30, 2005, the aggregate value of lending commitments outstanding was \$35.3 billion and \$37.0 billion, respectively. In connection with these business activities (which include funded corporate loans and lending commitments), the Company had hedges with a notional amount of \$23.8 billion and \$17.8 billion at May 31, 2006 and November 30, 2005, respectively, including both internal and external hedges utilized by the lending business. The table below shows the Company's credit exposure from its corporate lending positions and commitments as of May 31, 2006:

### Corporate Lending Commitments and Funded Loans

Credit Rating(1)	Years to Maturity				Total Corporate Lending Exposure(2)	Funded Corporate Loans
	Less than 1	1-3	3-5	Over 5		
	(dollars in millions)					
AAA	\$ 287	\$ 115	\$ 268	\$ —	\$ 670	\$ —
AA	2,806	1,747	2,381	552	7,486	2,783
A	1,285	2,624	4,520	1,393	9,822	453
BBB	2,805	2,489	8,771	1,216	15,281	2,935
Non-investment grade	3,789	1,296	2,849	3,205	11,139	2,950
Total	<u>\$10,972</u>	<u>\$8,271</u>	<u>\$18,789</u>	<u>\$6,366</u>	<u>\$44,398</u>	<u>\$9,121</u>
Notional amount of hedges owned					<u>\$23,822</u>	

(1) Obligor credit ratings are determined by Institutional Credit using methodologies generally consistent with those employed by external rating agencies.

(2) Total corporate lending exposure includes both lending commitments and funded loans.

**Credit Exposure-Derivatives.** The table below presents a summary by counterparty credit rating and remaining contract maturity of the fair value of OTC derivatives in a gain position at May 31, 2006. Fair value represents the risk reduction arising from master netting agreements, where applicable, and, in the final column, net of collateral received (principally cash and U.S. government and agency securities):

### OTC Derivative Products—Financial Instruments Owned(1)

Credit Rating(2)	Years to Maturity				Cross-Maturity and Cash Collateral Netting(3)	Net Exposure Post-Cash Collateral	Net Exposure Post-Collateral
	Less than 1	1-3	3-5	Over 5			
	(dollars in millions)						
AAA	\$ 1,723	\$ 1,309	\$ 1,306	\$ 1,893	\$ (1,768)	\$ 4,463	\$ 4,225
AA	7,895	4,630	5,342	10,813	(15,157)	13,523	12,841
A	3,943	2,581	2,583	6,861	(6,729)	9,239	8,002
BBB	4,177	3,286	3,144	3,031	(4,743)	8,895	6,711
Non-investment grade	3,489	2,029	2,519	2,104	(3,643)	6,498	3,632
Unrated(4)	1,365	624	169	346	(301)	2,203	217
Total	<u>\$22,592</u>	<u>\$14,459</u>	<u>\$15,063</u>	<u>\$25,048</u>	<u>\$(32,341)</u>	<u>\$44,821</u>	<u>\$35,628</u>

(1) Fair values shown present the Company's exposure to counterparties related to the Company's OTC derivative products. The table does not include the effect of any related hedges utilized by the Company. The table also excludes fair values corresponding to other credit exposures, such as those arising from the Company's lending activities.

- (2) Obligor credit ratings are determined by Institutional Credit using methodologies generally consistent with those employed by external rating agencies.
- (3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.
- (4) In lieu of making an individual assessment of the creditworthiness of unrated companies, the Company makes a determination that the collateral held with respect to such obligations is sufficient to cover a substantial portion of its exposure. In making this determination, the Company takes into account various factors, including legal uncertainties and market volatility.

The following tables summarize the fair values of the Company's OTC derivative products recorded in Financial instruments owned and Financial instruments sold, not yet purchased by product category and maturity at May 31, 2006, including on a net basis, where applicable, reflecting the fair value of related non-cash collateral for financial instruments owned:

#### OTC Derivative Products—Financial Instruments Owned

Product Type	Years to Maturity				Cross-Maturity and Cash Collateral Netting(1)	Net Exposure Post-Cash Collateral	Net Exposure Post- Collateral
	Less than 1	1-3	3-5	Over 5			
(dollars in millions)							
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts . . . . .	\$ 4,030	\$ 5,897	\$ 9,454	\$22,404	\$(23,274)	\$18,511	\$15,739
Foreign exchange forward contracts and options . . . . .	7,971	605	127	18	(690)	8,031	6,493
Equity securities contracts (including equity swaps, warrants and options) . . . . .	2,795	2,031	906	256	(1,586)	4,402	2,337
Commodity forwards, options and swaps . . . . .	7,796	5,926	4,576	2,370	(6,791)	13,877	11,059
<b>Total . . . . .</b>	<b>\$22,592</b>	<b>\$14,459</b>	<b>\$15,063</b>	<b>\$25,048</b>	<b>\$(32,341)</b>	<b>\$44,821</b>	<b>\$35,628</b>

- (1) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

#### OTC Derivative Products—Financial Instruments Sold, Not Yet Purchased(1)

Product Type	Years to Maturity				Cross-Maturity and Cash Collateral Netting(2)	Total
	Less than 1	1-3	3-5	Over 5		
(dollars in millions)						
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts . . . . .	\$ 3,829	\$ 6,382	\$6,191	\$14,429	\$(19,067)	\$11,764
Foreign exchange forward contracts and options . . .	8,332	501	83	37	(901)	8,052
Equity securities contracts (including equity swaps, warrants and options) . . . . .	3,284	2,214	1,093	717	(956)	6,352
Commodity forwards, options and swaps . . . . .	8,644	7,082	2,559	1,660	(7,579)	12,366
<b>Total . . . . .</b>	<b>\$24,089</b>	<b>\$16,179</b>	<b>\$9,926</b>	<b>\$16,843</b>	<b>\$(28,503)</b>	<b>\$38,534</b>

- (1) Since these amounts are liabilities of the Company, they do not result in credit exposures.
- (2) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category, where appropriate. Cash collateral paid is netted on a counterparty basis, provided legal right of offset exists.

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:

<u>Product Type</u>	<u>At May 31, 2006</u>		<u>At November 30, 2005</u>	
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
	(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
Total . . . . .	<u>\$51,536</u>	<u>\$48,747</u>	<u>\$45,894</u>	<u>\$44,952</u>

Each category of OTC derivative products in the above tables includes a variety of instruments, which can differ substantially in their characteristics. Instruments in each category can be denominated in U.S. dollars or in one or more non-U.S. currencies.

The fair values recorded in the above tables are determined by the Company using various pricing models. For a discussion of fair value as it affects the condensed consolidated financial statements, see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Results of Operations—Critical Accounting Policies" in Part I, Item 2 and Note 1 to the condensed consolidated financial statements. As discussed under "Critical Accounting Policies," the structure of the transaction, including its maturity, is one of several important factors that may impact the price transparency. The impact of maturity on price transparency can differ significantly among product categories. For example, single currency and multi-currency interest rate derivative products involving highly standardized terms and the major currencies (e.g., the U.S. dollar or the euro) will generally have greater price transparency from published external sources even in maturity ranges beyond 20 years. Credit derivatives with highly standardized terms and liquid underlying reference instruments can have price transparency from published external sources in a maturity ranging up to 10 years, while equity and foreign exchange derivative products with standardized terms in major currencies can have price transparency from published external sources within a two-year maturity range. Commodity derivatives with standardized terms and delivery locations can have price transparency from published external sources within various maturity ranges up to 10 years, depending on the commodity. In most instances of limited price transparency based on published external sources, dealers in these markets, in their capacities as market-makers and liquidity providers, provide price transparency beyond the above maturity ranges.

**Country Exposure.** The Company monitors its credit exposure and risk to individual countries. Credit exposure to a country arises from the Company's lending activities and derivatives activities in a country. At May 31, 2006, less than 6% of the Company's total credit exposure (including corporate loans, lending commitments and derivative contracts) was to emerging markets, and no one emerging market country accounted for more than 1% of the Company's total credit exposure. Country credit ratings are derived using methodologies generally consistent with those employed by external rating agencies.

**Industry Exposure.** The Company also monitors its credit exposure and risk to individual industries. At May 31, 2006, the Company's material credit exposure (including corporate loans, lending commitments and derivative contracts) was to entities engaged in the following industries: financial institutions, utilities, sovereign-related entities, consumer-related, forest/metals, and energy.

#### **Item 4. Controls and Procedures**

Under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

No change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) occurred during the period covered by this report that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## **Part II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

In addition to the matters described in the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2005 (the "Form 10-K"), the Company's Quarterly Report on Form 10-Q for the quarterly period ended February 28, 2006 (the "First Quarter Form 10-Q") and those described below, 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 these reviews, investigations and proceedings has increased in recent years with regard to many firms in the financial services industry, including the Company.

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 Note 8 in "Notes to Condensed Consolidated Financial Statements" in Part I, Item 1, 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 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.

(a) The following is a new matter reported by the Company.

#### **General American Litigation.**

On April 24, 2006, a Second Amended Petition captioned *Finke, et al. v. Morgan Stanley & Co. Incorporated, et al.*, was filed in the Missouri Circuit Court, Twenty-Second Judicial Circuit (St. Louis City), by the Director of the Department of Insurance for the State of Missouri and the Special Deputy Liquidator for General American Mutual Holding Company against Morgan Stanley & Co. Incorporated, the Company and a former officer of General American. The amended petition, which updated a petition first filed on or about July 28, 2004, asserts several causes of action against the Morgan Stanley defendants, including claims for fraud, breach of fiduciary duty, and negligent misrepresentation. The case arises out of the firm's investment banking work in connection with a potential demutualization and initial public offering of General American in 1998-1999. Fact discovery in the case is ongoing. Plaintiffs seek compensatory damages of over \$1 billion and punitive damages of over \$3 billion.

(b) The following developments have occurred with respect to certain matters previously reported in the Form 10-K and the First Quarter Form 10-Q.

#### **Coleman Litigation.**

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.

**IPO Fee Litigation.**

On April 18, 2006, in *In re Issuer Plaintiff Initial Public Offering Fee Antitrust Litigation*, the U.S. District Court for the Southern District of New York (the “SDNY”) denied plaintiffs’ motion for class certification. On May 1, 2006, plaintiffs filed a petition pursuant to Federal Rule of Civil Procedure 23(f) for leave to appeal the denial of class certification with the U.S. Court of Appeals for the Second Circuit (the “Second Circuit”).

**IPO Allocation Matters.**

On June 6, 2006, in *In re Initial Public Offering Securities Litigation*, the Second Circuit heard oral argument on defendants’ appeal of the SDNY’s grant of class certification in certain of these matters.

**Mutual Fund Sales Practices.**

On April 14, 2006, in *In re Morgan Stanley and Van Kampen Mutual Funds Securities Litigation*, the SDNY granted defendants’ motion to dismiss the consolidated amended complaint in its entirety and denied plaintiffs’ motion for leave to file a supplemental pleading. The time to notice an appeal of the Court’s rulings has expired.

**AOL Time Warner Litigation.**

In the Alaska action, the Company’s renewed motion to dismiss the plaintiffs’ amended claims under the Alaska Securities Act was granted on June 8, 2006. The only claim that remains against the Company in the Alaska action is one for negligent misrepresentation.

The numerous opt-out individual actions filed in various federal courts were transferred to the SDNY and consolidated. Plaintiffs have been filing amended complaints in these actions. On June 30, 2006, defendants filed motions to dismiss the claims common to all complaints.

**LVMH Litigation.**

On June 30, 2006, the Paris Court of Appeal (the “Appeal Court”) handed down its judgment. The Appeal Court overturned the Commercial Court’s findings in relation to the content of the Company’s research, including the finding of denigration, and overturned the Commercial Court’s award of €30 million. The Appeal Court upheld the Commercial Court’s decision on two issues, namely findings of errors in some of the Company’s disclosures and in one press interview, and appointed an expert to prepare a report on material damage suffered by LVMH Moët Hennessey Louis Vuitton as a result of those errors.

**Indonesian Litigation.**

On May 3, 2006, in the suit relating to the 1994 bond issue instituted in January 2005, the Indonesian District Court issued its judgment, declaring the bond issue to be null and void, holding that defendants (including the Company) had committed unspecified tortious acts, but awarding no damages. Defendants have appealed those decisions to the Indonesian High Court.

**Email Matters.**

On May 12, 2006, the U.S. District Court for the District of Columbia (the “D.C. District Court”) entered Final Judgment effecting a settlement the Company had reached with the SEC, the New York Stock Exchange, Inc. (“NYSE”) and the National Association of Securities Dealers, Inc. (the “NASD”) relating to Morgan Stanley & Co. Incorporated’s (“MS&Co.’s”) production of email in the research analyst and IPO investigations from December 2000 through at least July 2005. The complaint, filed by the SEC in the District Court on May 10, 2006, alleges that MS&Co. did not timely produce emails in response to requests in those matters because it did not diligently search for back-up tapes containing responsive emails until 2005, and because it over-wrote back-up tapes potentially containing responsive email until at least December 2002. Without admitting or denying the allegations of the complaint, MS&Co. consented to (1) a permanent injunction barring future violations of §17(b) of the Exchange Act (which requires, among other things, that the Company respond promptly to SEC subpoenas and requests) and the relevant regulations promulgated thereunder and (2) the payment of a \$15 million civil penalty, \$5 million of which will be paid to the NASD and the NYSE.

### **Global Wealth Management Employment Matters.**

In *Garett v. Morgan Stanley & Co., Inc., and Morgan Stanley DW Inc.*, the U.S. District Court for the Southern District of California granted preliminary approval of the parties' settlement.

Additional complaints raising wage and hour allegations against the Company have also been filed in Connecticut and New Jersey. On May 22, 2006, a purported class action, captioned *Janemarie Lenihan v. Morgan Stanley & Co., Inc. and Morgan Stanley DW Inc.*, was filed in the U.S. District Court for the District of Connecticut. On May 22, 2006, a second matter, captioned *Robert Adler et al. v. Morgan Stanley & Co., Inc. and Morgan Stanley DW Inc.*, was filed in the Superior Court of New Jersey, Law Division, Bergen County.

The Company has also been named in two purported class actions alleging gender discrimination under state and federal law. On June 22, 2006, a purported class action, captioned *Joanne Augst-Johnson et al. v. Morgan Stanley DW Inc.*, was filed in the D.C. District Court. On June 22, 2006, a second purported class action captioned *Daisy Jaffe v. Morgan Stanley DW Inc.*, was filed in the U.S. District Court for the Northern District of California. Plaintiffs seek damages in law and in equity.

### **Item 1A. Risk Factors**

See "Risk Factors" in Part I, Item 1A of the Form 10-K.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The table below sets forth the information with respect to purchases made by or on behalf of the Company of the Company's common stock during the quarterly period ended May 31, 2006.

### Issuer Purchases of Equity Securities (dollars in millions, except per share amounts)

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs (C)	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
<b>Month #1 (March 1, 2006 – March 31, 2006)</b>				
Equity Anti-dilution Program (A) . . . . .	—	\$ —	—	(A)
Capital Management Program (B) . . . . .	—	N/A	—	\$600
Employee Transactions (D) . . . . .	291,541	\$61.98	N/A	N/A
<b>Month #2 (April 1, 2006 – April 30, 2006)</b>				
Equity Anti-dilution Program (A) . . . . .	285,900	\$63.98	285,900	(A)
Capital Management Program (B) . . . . .	—	N/A	—	\$600
Employee Transactions (D) . . . . .	159,671	\$64.32	N/A	N/A
<b>Month #3 (May 1, 2006 – May 31, 2006)</b>				
Equity Anti-dilution Program (A) . . . . .	1,480,598	\$63.95	1,480,598	(A)
Capital Management Program (B) . . . . .	—	N/A	—	\$600
Employee Transactions (D) . . . . .	311,536	\$59.12	N/A	N/A
<b>Total</b>				
Equity Anti-dilution Program (A) . . . . .	1,766,498	\$63.96	1,766,498	(A)
Capital Management Program (B) . . . . .	—	N/A	—	\$600
Employee Transactions (D) . . . . .	762,748	\$61.31	N/A	N/A

- (A) The Company's board of directors authorized this program to purchase common stock to offset the dilutive impact of grants and exercises of awards under the Company's equity-based compensation and benefit plans. The program was publicly announced on January 7, 1999 and has no set expiration or termination date. There is no maximum amount of shares that may be purchased under the program.
- (B) The Company's board of directors authorized this program to purchase common stock for capital management purposes. The program was publicly announced on February 12, 1998 at which time up to \$3 billion of stock was authorized to be purchased. The program was subsequently increased by \$1 billion on December 18, 1998, \$1 billion on December 20, 1999 and \$1.5 billion on June 20, 2000. This program has a remaining capacity of \$600 million at May 31, 2006 and has no set expiration or termination date.
- (C) Share purchases under publicly announced programs are made pursuant to open-market purchases, Rule 10b5-1 plans or privately negotiated transactions (including with employee benefit plans) as market conditions warrant and at prices the Company deems appropriate.
- (D) Includes: (1) shares delivered or attested to in satisfaction of the exercise price and/or tax withholding obligations by holders of employee stock options (granted under employee stock compensation plans) who exercised options; (2) restricted shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon vesting and release of restricted shares; and (3) shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon the delivery of outstanding shares underlying restricted stock units. The Company's employee stock compensation plans provide that the value of the shares delivered or attested, or withheld, shall be the average of the high and low price of the Company's common stock on the date the relevant transaction occurs.

## Item 4. Submission of Matters to a Vote of Security Holders

Information regarding the submission of matters to a vote of security holders under Item 8.01 of the Company's Current Report on Form 8-K filed on April 4, 2006 is incorporated by reference herein.

## Item 6. Exhibits

An exhibit index has been filed as part of this Report on Page E-1.



**EXHIBIT INDEX**  
**MORGAN STANLEY**  
**Quarter Ended May 31, 2006**

<u>Exhibit No.</u>	<u>Description</u>
3.1 and 4.1	Certificate of Designation (Exhibit 3.1 and 4.1 to the Company's Current Report on Form 8-K dated July 5, 2006).
3.2	Amended and Restated Bylaws, as amended to date (Exhibit 3 to the Company's Current Report on Form 8-K dated June 20, 2006).
4.2	Certificate representing the Series A Preferred Stock.
4.3	Deposit Agreement dated as of July 6, 2006 among the Company, JPMorgan Chase Bank, N.A. and the holders from time to time of the depositary receipts described therein.
4.4	Depositary Receipt for Depositary Shares, representing Floating Rate Non-Cumulative Preferred Stock, Series A (included in Exhibit 4.3 hereto).
10.1	Tax Deferred Equity Participation Plan, amended and restated as of June 20, 2006.
10.2	Morgan Stanley Financial Advisor Productivity Compensation Plan, amended and restated as of June 20, 2006.
10.3	Morgan Stanley Performance Formula and Provisions.
10.4	Morgan Stanley Schedule of Non-Employee Directors Retainers, effective July 6, 2006 (Exhibit 10 to the Company's Current Report on Form 8-K dated June 20, 2006).
11	Statement Re: Computation of Earnings Per Common Share (The calculation of per share earnings is in Part I, Item 1, Note 7 to the Condensed Consolidated Financial Statements (Earnings per Share) and is omitted in accordance with Section (b)(11) of Item 601 of Regulation S-K).
12	Statement Re: Computation of Ratio of Earnings to Fixed Charges and Computation of Earnings to Fixed Charges and Preferred Stock Dividends.
15	Letter of awareness from Deloitte & Touche LLP, dated July 6, 2006, concerning unaudited interim financial information.
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer.

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