Morgan Stanley

Pillar 3 *Disclosure (U.K.)*

As at 31 December 2009

1. BASEL II ACCORD

The Basel II Accord as detailed in "International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version" June 2006, has been implemented in the European Union via the Banking Consolidation Directive and the Capital Adequacy Directive collectively known as the Capital Requirements Directive ("CRD").

The framework consists of three "pillars." Pillar 1 of the new standards sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors are required to assess the appropriateness of the Pillar 1 level of capital that Morgan Stanley Smith Barney Holdings (U.K.) Limited and its subsidiaries (the "MSSB U.K. Group") require, taking into account risks not covered in Pillar 1, and must take action accordingly. The aim of Pillar 3 is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess certain specified information in relation to capital adequacy, particular risk exposures and risk management processes.

2. BACKGROUND TO PILLAR 3 DISCLOSURES

The MSSB U.K. group commenced trading on the 1 June 2009. As a result, this is the first MSSB U.K. Group Pillar 3 disclosure. The MSSB U.K. Group's ultimate parent undertaking and controlling entity is Morgan Stanley, a Delaware corporation, which, together with its consolidated subsidiaries, form the Morgan Stanley Group ("Morgan Stanley Group"). Morgan Stanley is a "Financial Holding company" as defined by the Bank Holding Company Act of 1956, as amended, and is subject to regulation by the Board of Governors of the Federal Reserve System.

Morgan Stanley currently calculates its capital ratios and risk-weighted assets in accordance with the capital adequacy standards for Financial Holding companies adopted by the Federal Reserve, which are based upon a framework described in the "International Convergence of Capital Measurement and Capital Standards," July 1988, as amended, also referred to as "Basel I." U.S. banking regulators are in the process of incorporating the Basel II Accord into the existing risk–based capital requirements and Morgan Stanley is working with its regulators accordingly to transition to these requirements.

Morgan Stanley is listed on the New York Stock Exchange and is required, by the U.S. Securities and Exchange Commission ("SEC"), to file public disclosures, including Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. These disclosures can be found at **http://www.morganstanley.com/about/ir/sec_filings.html.**

Morgan Stanley Smith Barney was created on 1 June 2009 following agreement between Morgan Stanley and Citigroup Inc ("Citi") to combine Morgan Stanley's Global Wealth Management Group and Citi's Smith Barney, Quilter, Executive Share Ownership Plans business ("ESOP"), Global Stock Plan Services Business ("GSPS") in the U.K. and Smith Barney Australia into a new joint venture to be called Morgan Stanley Smith Barney ("MSSB"). Under the terms of the agreement, Citi exchanged among other things 100 percent of its Smith Barney, Smith Barney Australia, Quilter, ESOP and GSPS units for a 49 percent stake in the joint venture. Morgan Stanley exchanged 100 percent of its Global Wealth Management business and $2.7 billion for a 51 percent stake in the joint venture.

The information disclosed in this document is not necessarily indicative of the Morgan Stanley Group as a whole, nor is it comprehensively representative of the Morgan Stanley Group's activity in any particular region. Investors, stakeholders, creditors or other users seeking information on capital adequacy, risk exposure and risk management policies should consult the public disclosures of Morgan Stanley Group, as this will provide a more comprehensive view.

Public disclosures, including those required under Pillar 3 both by the Federal Reserve and the Financial Services Authority ("FSA"), will continue to evolve over time. The qualitative and quantitative information contained in this document represents the position of the MSSB U.K. Group as at 31 December 2009. Amendments to the MSSB U.K. Group's operating model and risk management procedures that have occurred following this date are not discussed in this document.

The majority of the numerical disclosures in this document are calculated by reference to FSA's methodology for risk exposure and are not necessarily the primary exposure measures used by internal management.

This document does not constitute a set of financial statements. The MSSB U.K. Group's financial statements have been prepared in accordance with applicable United Kingdom ("U.K.") law and International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU"). Information disclosed in the MSSB U.K. Group financial statements will not necessarily be consistent with information disclosed in this document. Trading Book and Non Trading Book definitions used in this document refer to the regulatory view and may differ from the accounting definitions.

3. APPLICATION OF THE PILLAR 3 FRAMEWORK

This document represents the annual public Pillar 3 qualitative and quantitative disclosures required by the FSA prudential sourcebook rules for Banks, Building Societies and Investment Firms ("BIPRU") in relation to the MSSB U.K. Group.

The basis of consolidation for prudential purposes is materially the same as consolidation for accounting purposes. The MSSB U.K. Group completes its prudential consolidation in compliance with BIPRU, Section 8. The principal subsidiary undertakings of the MSSB U.K. Group are listed in the annual financial statements of the MSSB U.K. Group, Company disclosures note 6. The MSSB U.K. Group has a policy in place to assess the appropriateness of its Pillar 3 disclosures, including their verification and frequency.

4. MORGAN STANLEY SMITH BARNEY HOLDINGS (U.K.) LIMITED

The principal activity of the MSSB U.K. Group is the provision of financial services to individual investors, corporations and financial institutions on a discretionary or advisory basis. The MSSB U.K. Group commenced trading on 1 June 2009. There have not been any significant changes in the MSSB U.K. Group's principal activities in the period under review and no significant change in the MSSB U.K. Group's principal business is expected.

As at 31 December 2009, the following entities within the MSSB U.K. Group were regulated by the FSA:

- Morgan Stanley Private Wealth Management Limited ("MS PWM")
- Quilter & Co Limited ("Quilter")
- Quilter Fund Management Ltd

As at 31 December 2009, there were no entities that were deducted from the MSSB U.K. Group's capital resources.

The MSSB U.K. Group calculates capital requirements in accordance with the regulatory capital requirements of the FSA and, in turn, with guidelines described under the Basel II Accord.

5. CAPITAL RESOURCES

Under FSA supervision, the MSSB U.K. Group is required to maintain a minimum ratio of total capital resources to capital requirements. As at 31 December 2009, the MSSB U.K. Group was in full compliance with the FSA capital requirements as defined by BIPRU. The FSA handbook can be found at **http://fsahandbook.info/FSA/html/handbook/BIPRU.** All capital resources are included in Tiers 1, 2 and 3 and are of standard form and the main terms and conditions of the capital instruments disclosed below are disclosed in the MSSB U.K. Group financial statements, see note 17 for subordinated debt disclosures and note 21 for share capital disclosures.

The table below shows the financial resources that the MSSB U.K. Group had as at 31 December 2009 based upon the audited financial statements:

Capital Resources Table

As at 31/12/2009	Quilter $thousands	MS PWM $thousands	MSSB U.K. Group Consolidated $thousands
Permanent share capital	15,353	1	-
Profit and loss account and other reserves	89,966	(7,149)	2,532
Share premium account	-	60,550	180,551
Less: Intangible assets	(2,060)	(18,450)	(34,444)
Tier 1 capital resources	**103,258**	**34,952**	**148,639**
Tier 2 capital resources	**-**	**17,476**	**20,000**
Tier 1 plus tier 2 capital after deductions	**103,258**	**52,428**	**168,639**
Tier 3 capital resources	**-**	**-**	**-**
Less: Deductions from total capital	(2,449)	-	(2,449)
TOTAL CAPITAL RESOURCES, NET OF DEDUCTIONS	100,809	52,428	166,190

Permanent share capital and subordinated loans included in financial resources are consistent with MSSB U.K. Group financial statements. The General Prudential sourcebook ("GENPRU") sections 1 and 2 define the items that are included or deducted from the profit and loss account and other reserves to arrive at total financial resources. As a result, the profit and loss account and other reserves balance noted above will differ to the MSSB U.K. financial statements.

There are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities among the MSSB U.K. Group and its subsidiary undertakings.

Management reviews capital levels on an ongoing basis in light of changing business needs and the external environment. Management ensures that appropriate levels of capital are maintained to support business needs whilst remaining in compliance with the target operating range established by the relevant governing bodies and applicable regulatory requirements.

6. CAPITAL REQUIREMENTS

The MSSB U.K. Group calculates Pillar 1 capital requirements in accordance with the regulatory capital requirements of the FSA. As at 31 December 2009, the MSSB U.K. Group had the following capital requirements:

Capital Requirements Table

As at 31/12/2009	Quilter $thousands	MS PWM $thousands	MSSB U.K. Group Consolidated $thousands
Credit risk capital component	5,800	2,594	8,391
Counterparty risk capital component	216	-	216
Market risk capital component	202	589	791
Operational risk—Basic Indicator Approach	15,162	18,541	33,703
	21,380	21,724	43,101

Credit and counterparty risk capital components reflect capital charges attributable to the risk of loss arising from a borrower or counterparty failing to meet its financial obligations. Risk weighted exposures are determined using the standardised approach. For a further discussion see section 10 Credit Risk.

The market risk capital component reflects capital charges attributable to the risk of loss resulting from adverse changes in market prices and other factors. The market risk capital of the MSSB U.K. Group comprises capital associated with the standardised approach. For a further discussion see section 11 Market Risk.

Operational risk capital charges are designed to account for the risk of losses due to inadequate or failed internal processes, people and systems, or external events and take into account legal risk. Capital requirements for operational risk are currently calculated under the Basic Indicator Approach. For a further discussion, see section 12 Operational Risk.

The risk capital calculations will evolve over time as the MSSB U.K. Group enhances its risk management strategy and incorporates improvements in modeling techniques while maintaining compliance with the regulatory requirements.

7. APPLICATION OF THE PILLAR 2 FRAMEWORK

The MSSB U.K. Group employs an Economic Capital framework in order to meet its obligations under BIPRU 2.2 “Internal capital adequacy standards,” whereby additional capital for stress losses is calculated and held.

The Economic Capital framework is used to ensure that the MSSB U.K. Group carries, or has access to, sufficient capital to support all material risks residing within the MSSB U.K. Group, by providing a “cross check” on U.K. regulatory capital and is based on management’s own risk assessment. The MSSB U.K. Group’s U.K. economic capital framework has been reviewed by the FSA.

8. RISK MANAGEMENT OBJECTIVES AND POLICIES

Risk is an inherent part of MSSB U.K. Group’s business activity and is managed by the MSSB U.K. Group within the context of the Morgan Stanley Group global framework. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities in accordance with defined policies and procedures. The MSSB U.K. Group’s own risk management objectives, policies and procedures are consistent with those of the Morgan Stanley Group.

As noted previously, Morgan Stanley is required to make quarterly filings with the SEC. For further discussion of Morgan Stanley’s risk management objectives, policies and procedures, see pages 89-111 of 31 December 2009 Form 10-K.

9. ACCOUNTING POLICIES

The MSSB U.K. Group’s financial statements have been prepared in accordance with applicable U.K. law and IFRS as adopted by the EU. Further information regarding the accounting policies of the MSSB U.K. Group including measurement considerations, can be found in note 2 of the financial statements.

10. CREDIT RISK

10.1 Credit Exposure

The Morgan Stanley Group manages credit risk exposure on a global basis, but in consideration of each individual legal entity. The credit risk management policies and procedures of the Morgan Stanley Group include ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit and escalating risk concentrations to appropriate senior management. Credit risk management policies and procedures for the MSSB U.K. Group are consistent with those of the Morgan Stanley Group and include escalation to appropriate key management personnel of the MSSB U.K. Group.

The Morgan Stanley Group is exposed primarily to significant single-name credit risk, requiring credit analysis of specific counterparties, both initially and on an ongoing basis. Credit risk management takes place at the transaction, counterparty and portfolio levels. In order to help protect the MSSB U.K. Group from losses resulting from its business activities, the MSSB U.K. Group analyses all material lending and ensures that the creditworthiness of the MSSB U.K. Group’s counterparties and borrowers is reviewed regularly and that credit exposure is actively monitored and managed. For lending transactions, the MSSB U.K. Group evaluates the relative position of its particular exposure in the borrower's capital structure and relative recovery prospects. Where applicable, the MSSB U.K. Group also considers collateral arrangements and other structural elements of the particular transaction. The MSSB U.K. Group has credit guidelines that limit potential credit exposure to any one borrower or counterparty and to aggregates of borrowers or counterparties; these limits are monitored and credit exposures relative to these limits are reported to key management personnel.

MSSB U.K. Group is a collateralized business, which serves to limit the credit exposure. The MSSB U.K. Group business is exposed to credit risk through margin lending to its MS PWM and Quilter clients. Demand loans are callable with short notice periods. Proposed loans are subject to review and approval by the appropriate risk and credit committees. MSSB U.K. Group has dedicated staff to carry out its credit risk management in accordance with the direction set by the MSSB U.K. Group Risk Management and Firm Risk Management functions. There are strict controls around collateral management, including the type of collateral, collateral levels, and legal title.

10.2 Counterparty and Credit Risk Capital Component ("CRCC")

The credit risk capital component reflects capital requirements attributable to the risk of loss arising from a borrower or counterparty failing to meet its obligations. Risk weighted exposures are determined using the standardised approach to credit risk.

The FSA industry type is aligned with the classifications set out in BIPRU. Institutions includes financial institutions not only credit institutions. A standardised approach is used for all asset categories. The nominated external credit assessment institution ("ECAI") is Standard and Poor's ("S&P") which has been used for all standardised credit risk exposure classes.

10.3 Credit Exposure Breakdown Table

Standardised Approach Exposure Table

As at 31/12/2009	Credit Quality Step	Total Gross Exposure $thousands	Total exposure value covered by eligible financial collateral $thousands	Exposure value after credit risk mitigation $thousands	CRCC $thousands
Sovereigns	1	48,006	0	48,006	0
Institutions	2	116,317	0	116,317	2,181
Institutions	3	8,168	1,605	6,563	525
Corporates	3	122,905	107,651	15,254	1,220
Other	3	61,192	5,385	55,807	4,680
TOTAL		356,588	114,642	241,946	8,607

Gross credit exposure reported above is based upon the regulatory definition as agreed with the FSA on a product by product basis, prior to netting and collateral being applied, but after regulatory eliminations and exemptions are applied. Where appropriate this also includes regulatory haircuts. These numbers are therefore different to those presented in MSSB U.K. Group's financial statements. Exposures are consistent with Regulatory returns and from a Risk management perspective, collateral is available.

"Exposure value covered by eligible financial collateral," represents the positive market value against which collateral has been received and for which the required legal netting agreements exist in order to enable collateral to be applied. Net credit exposure is the exposure at default ("EAD") calculated under the rules prescribed in BIPRU upon which regulatory capital charges are calculated.

Geographical Breakdown of EAD

As at 31/12/2009	Americas $thousands	Asia $thousands	EMEA $thousands	Total $thousands
Sovereign	48,006	0	0	48,006
Institutions	26,702	708	95,470	122,880
Corporate	1,191	19	14,045	15,254
Other	62	0	55,745	55,807
TOTAL CREDIT EXPOSURE	75,961	727	165,259	241,946

As well as assessing and monitoring its credit exposure and risk at the individual counterparty level, the MSSB U.K. Group also reviews its credit exposure and risk to geographic regions. As at 31 December 2009, credit exposure was concentrated in Western European and North American countries. In addition, the MSSB U.K. Group pays particular attention to smaller exposures in emerging markets given their higher risk profile.

The MSSB U.K. Group also reviews its credit exposure and risk to types of customers. At 31 December 2009, the MSSB U.K. Group's material credit exposure was to institutions, sovereigns, corporate entities and others (which are primarily individuals).

10.4 Credit Risk Mitigation

The MSSB U.K. Group applies a number of credit risk mitigation techniques, including netting and collateral.

Netting

The MSSB U.K. Group has policies and procedures in place for recording netting agreements with clients, including the review of the legal enforceability of these agreements. In instances where there is doubt over the legal enforceability of an agreement, the benefit of netting is not applied for the purposes of capital reporting. See section 10.3 Credit Exposure Breakdown Table for the impact of netting and collateral.

Collateral

The amount and type of collateral required by the MSSB U.K. Group depends on an assessment of the credit risk of the counterparty. Collateral held is managed in accordance with the MSSB U.K. Group's guidelines and the relevant underlying agreements. The market value of securities received as collateral is monitored on a daily basis and securities provided as collateral generally are not recognised on the consolidated statement of financial position.

The Morgan Stanley Group actively manages its credit exposure through the application of collateral arrangements. The use of collateral in managing OTC derivative risk is standard in the market place, and is governed by appropriate documentation, for example, the Credit support Annex to the ISDA documentation. In line with these standards, the Morgan Stanley Group generally accepts only cash and G7 government bonds, corporate debt and main index equities as eligible collateral. Other securities may be accepted in securities lending, repo, prime brokerage and private wealth management (MSSB U.K. Group) subject to conservative haircuts based on assessments of collateral volatility and liquidity. There is an established and robust infrastructure to manage, maintain and value collateral on a daily basis.

Collateralised EAD relates to PWM Margin Loans that are callable on demand. Unsecured EAD relates mainly to cash balances and intercompany receivable balances. All EAD has a maturity less then one year.

11. MARKET RISK

11.1 Market Risk Capital Component

Market risk is defined under IFRS 7 as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. The MSSB U.K. Group is exposed to the following types of market risk under this definition; interest rate risk and currency risk.

11.2 Market Risk Drivers

The MSSB U.K. Group has foreign currency exposure arising from its investments in branches and subsidiaries where those investments operate in currencies other than U.S. dollars. The majority of this foreign currency risk has been hedged by other members of the Morgan Stanley Group, primarily Morgan Stanley, by utilising both forward foreign currency exchange contracts and non-U.S. dollar denominated debt.

For the MSSB U.K. Group, typically, lending is matched to funding rates resulting in little direct market risk. Market Risk is derived from the structural mix of the balance sheet in different currencies.

12. OPERATIONAL RISK

12.1 Overview

Operational risk refers to the risk of financial or other loss, or potential damage to a firm's reputation, arising from inadequate or failed internal processes, people, resources and systems, or from external events (e.g. external or internal fraud, legal and compliance risks, damage to physical assets, etc.).

MSSB U.K. group may incur operational risk across its full scope of business activities, including revenue generating activities (e.g. advisory and discretionary activities) and support functions (e.g. information technology and facilities management). Legal, residual, regulatory, reputational and valuation risk are included in the scope of operational risk. Operational risk is an inherent part of the business and activities of the MSSB U.K. group. The extent to which MSSB U.K. group properly identifies, assesses, monitors and mitigates the Operational Risks associated with business activities is critical to its soundness and profitability. For completeness, all Legal Entities, business and support divisions within MSSB U.K. group are considered for operational risk and capital adequacy purposes.

NY CS 6633082 03/11