

MORGAN STANLEY  
Form 10-K  
February 13, 2007  
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# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended November 30, 2006

Commission File Number 1-11758

## Morgan Stanley

(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

1585 Broadway

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

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

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

Title of each class	Name of exchange on which registered
<b>Securities registered pursuant to Section 12(b) of the Act:</b>	
Common Stock, \$0.01 par value	New York Stock Exchange
Depository Shares, each representing 1/1,000th interest in a share of Floating Rate Non-Cumulative Preferred Stock, Series A, \$0.01 par value	New York Stock Exchange
8.03% Capital Units	New York Stock Exchange
7 1/4% Capital Securities of Morgan Stanley Capital Trust II (and Registrant's guaranty with respect thereto)	New York Stock Exchange
6 1/4% Capital Securities of Morgan Stanley Capital Trust III (and Registrant's guaranty with respect thereto)	New York Stock Exchange
6 1/4% Capital Securities of Morgan Stanley Capital Trust IV (and Registrant's guaranty with respect thereto)	New York Stock Exchange
5 3/4% Capital Securities of Morgan Stanley Capital Trust V (and Registrant's guaranty with respect thereto)	New York Stock Exchange
6.60% Capital Securities of Morgan Stanley Capital Trust VI (and Registrant's guaranty with respect thereto)	New York Stock Exchange
6.60% Capital Securities of Morgan Stanley Capital Trust VII (and Registrant's guaranty with respect thereto)	New York Stock Exchange
SPARQSM due February 20, 2007 (2 issuances); SPARQS due March 20, 2007 (2 issuances); SPARQS due April 20, 2007; SPARQS due May 20, 2007; SPARQS due June 20, 2007; SPARQS due August 20, 2007; SPARQS due September 20, 2007 (2 issuances); SPARQS due October 20, 2007 (2 issuances); SPARQS due November 20, 2007; SPARQS due December 20, 2007 (2 issuances); SPARQS due January 20, 2008 (2 issuances); SPARQS due February 20, 2008	American Stock Exchange
Exchangeable Notes due December 30, 2008 (2 issuances); Exchangeable Notes due December 30, 2010; Exchangeable Notes due April 30, 2011; Exchangeable Notes due June 30, 2011	American Stock Exchange
Callable Index-Linked Notes due December 30, 2008	American Stock Exchange
BRIDGES <sup>SM</sup> due August 30, 2008; BRIDGES due December 30, 2008 (2 issuances); BRIDGES due February 28, 2009; BRIDGES due March 30, 2009; BRIDGES due June 30, 2009; BRIDGES due July 30, 2009; BRIDGES due August 30, 2009; BRIDGES due October 30, 2009; BRIDGES due December 30, 2009; BRIDGES due June 15, 2010	American Stock Exchange American Stock Exchange

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Capital Protected Notes due June 30, 2008; Capital Protected Notes due July 20, 2008; Capital Protected Notes due September 30, 2008; Capital Protected Notes due December 30, 2008; Capital Protected Notes due December 30, 2009; Capital Protected Notes due April 20, 2010; Capital Protected Notes due July 20, 2010 (2 issuances); Capital Protected Notes due August 30, 2010; Capital Protected Notes due October 30, 2010; Capital Protected Notes due January 30, 2011; Capital Protected Notes due March 30, 2011 (2 issuances); Capital Protected Notes due June 30, 2011; Capital Protected Notes due October 30, 2011; Capital Protected Notes due December 30, 2011; Capital Protected Notes due September 30, 2012  
Capital Protected Notes due September 1, 2010

The NASDAQ Stock Market LLC

HITS<sup>SM</sup> due March 20, 2007; HITS due April 20, 2007; HITS due May 20, 2007; HITS due June 20, 2007; HITS due December 20, 2007; HITS due January 20, 2008; HITS due February 20, 2008

American Stock Exchange

MPSS<sup>SM</sup> due December 30, 2008; MPS due December 30, 2009; MPS due February 1, 2010; MPS due June 15, 2010; MPS due December 30, 2010 (2 issuances); MPS due March 30, 2012

American Stock Exchange

MPS due March 30, 2009

The NASDAQ Stock Market LLC

Stock Participation Notes due September 15, 2010; Stock Participation Notes due December 30, 2010

American Stock Exchange

PLUS<sup>SM</sup> due February 20, 2007; PLUS due March 20, 2007; PLUS due April 20, 2007; PLUS due April 30, 2007; PLUS due June 20, 2007; PLUS due July 20, 2007; PLUS due September 20, 2007; PLUS due October 20, 2007 (2 issuances); PLUS due November 20, 2007 (2 issuances); PLUS due January 20, 2008; PLUS due February 20, 2008; PLUS due March 20, 2008; PLUS due April 30, 2008; PLUS due June 30, 2009

American Stock Exchange

PLUS due February 20, 2007; PLUS due July 20, 2007; PLUS due August 20, 2007; PLUS due September 30, 2009

The NASDAQ Stock Market LLC

PROPELS<sup>SM</sup> due December 30, 2011 (3 issuances)

American Stock Exchange

Strategic Total Return Securities due December 17, 2009; Strategic Total Return Securities due March 30, 2010; Strategic Total Return Securities due July 30, 2011 (2 issuances); Strategic Total Return Securities due January 15, 2012

American Stock Exchange

Strategic Total Return Securities due October 30, 2011

The NASDAQ Stock Market LLC

BOXES<sup>SM</sup> due October 30, 2031; BOXES due January 30, 2032

American Stock Exchange

Philadelphia Stock Exchange

### Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES x NO "

Indicate by check mark if Registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. YES " NO x

Indicate by check mark whether 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 Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO "

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. "

Indicate by check mark whether Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Exchange Act Rule 12b-2. Large accelerated filer x Accelerated filer Non-accelerated filer "

Indicate by check mark whether Registrant is a shell company (as defined in Exchange Act Rule 12b-2). YES " NO x

As of May 31, 2006, the aggregate market value of the common stock of Registrant held by non-affiliates of Registrant was approximately \$63,258,828,406.58. This calculation does not reflect a determination that persons are affiliates for any other purposes.

As of January 31, 2007, there were 1,066,418,476 shares of Registrant's common stock, \$.01 par value, outstanding.

**Documents Incorporated By Reference:** Portions of Registrant's definitive proxy statement for its annual stockholders' meeting to be held on April 10, 2007 are incorporated by reference in Part III of this Form 10-K.

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**Forward-Looking Statements**

We have included or incorporated by reference into this report, and from time to time may make in our public filings, press releases or other public statements, certain statements, including (without limitation) those under **Legal Proceedings** in Part I, Item 3, **Management's Discussion and Analysis of Financial Condition and Results of Operations** in Part II, Item 7 and **Quantitative and Qualitative Disclosures about Market Risk** in Part II, Item 7A, that may constitute forward-looking statements. In addition, our management may make forward-looking statements to analysts, investors, representatives of the media and others. These forward-looking statements are not historical facts and represent only Morgan Stanley's beliefs regarding future events, many of which, by their nature, are inherently uncertain and beyond our control.

The nature of Morgan Stanley's business makes predicting the future trends of our revenues, expenses and net income difficult. The risks and uncertainties involved in our businesses could affect the matters referred to in such statements and it is possible that our actual results may differ from the anticipated results indicated in these forward looking statements. Important factors that could cause actual results to differ from those in the forward-looking statements include (without limitation):

the expected timing and completion of the proposed distribution to Morgan Stanley's shareholders of all of the outstanding shares of Discover;

the credit ratings assigned to Morgan Stanley;

the effect of political, economic and market conditions and geopolitical events;

the availability and cost of capital;

the level and volatility of equity prices, commodity prices and interest rates, currency values and other market indices;

the actions and initiatives of current and potential competitors;

the impact of current, pending and future legislation, regulation and regulatory and legal actions in the U.S. and worldwide;

our reputation;

investor sentiment;

the potential effects of technological changes; and

other risks and uncertainties detailed under **Risk Factors** in Part I, Item 1A, **Competition** and **Regulation** in Part I, Item 1 and elsewhere throughout this report.

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Accordingly, you are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date on which they are made. Morgan Stanley undertakes no obligation to update publicly or revise any forward-looking statements to reflect the impact of circumstances or events that arise after the dates they are made, whether as a result of new information, future events or otherwise except as required by applicable law. You should, however, consult further disclosures Morgan Stanley may make in future filings of its Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K and any amendments thereto or in future press releases or other public statements.

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**Part I**

**Item 1. Business.**

**Overview.**

Morgan Stanley is a global financial services firm that, 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. Morgan Stanley was originally incorporated under the laws of the State of Delaware in 1981, and its predecessor companies date back to 1924. Morgan Stanley conducts its business from its headquarters in and around 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. At November 30, 2006, Morgan Stanley had 55,310 employees worldwide. Unless the context otherwise requires, the terms Morgan Stanley, the Company, we and our mean Morgan Stanley and its consolidated subsidiaries.

Financial information concerning Morgan Stanley, our business segments and geographic regions for each of the fiscal years ended November 30, 2006, November 30, 2005 and November 30, 2004 is included in the consolidated financial statements and the notes thereto in Financial Statements and Supplementary Data in Part II, Item 8.

**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 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 its Investor Relations webpage, via a link to the SEC's internet site, statements of beneficial ownership of Morgan Stanley's equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

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

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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;

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Code of Ethics and Business Conduct; and

Integrity Hotline.

Morgan Stanley's Code of Ethics and Business Conduct applies to all directors, officers and employees, including its Chief Executive Officer, its Chief Financial Officer and its Controller and Principal Accounting Officer. Morgan Stanley will post any amendments to the Code of Ethics and Business Conduct and any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, Inc. ( NYSE ) on its internet site. You can request a copy of these documents, excluding exhibits, at no cost, by contacting Investor Relations, 1585 Broadway, New York, NY 10036 (212-761-4000). The information on Morgan Stanley's internet site is not incorporated by reference into this report.

## **Business Segments.**

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. A summary of the activities of each of the business 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 services; retirement services; and trust and fiduciary services.

***Asset Management*** provides global asset management products and services in equity, fixed income, alternative investments and private equity to institutional and retail clients through proprietary and third party retail distribution channels, intermediaries and Morgan Stanley's institutional distribution channel. Asset Management also engages in investment activities.

***Discover*** offers Discover®-branded credit cards and related consumer products and services and operates the Discover Network, 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. Discover also offers consumer finance products and services in the U.K., including Morgan Stanley-branded, Goldfish-branded and various other credit cards issued on the MasterCard® and Visa® networks.

On December 19, 2006, Morgan Stanley announced that its Board of Directors had approved the spin-off of Discover in order to enhance shareholder value (the Discover Spin-off ). The Discover Spin-off will allow the Company to focus its efforts on more closely aligned firm-wide strategic priorities within its Institutional Services, Global Wealth Management Group and Asset Management business segments. The Discover Spin-off is subject to regulatory approval and other customary conditions, and is expected to take place in the third quarter of 2007. At the time



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of the Discover Spin-off, Morgan Stanley shareholders will receive shares in Discover on a tax-free basis.

### **Institutional Securities.**

Morgan Stanley provides financial advisory and capital-raising services to a diverse group of corporate and other institutional clients globally, primarily through wholly-owned subsidiaries that include Morgan Stanley & Co. Incorporated ( MS&Co. ), Morgan Stanley & Co. International Limited, Morgan Stanley Japan Securities Co., Ltd. and Morgan Stanley Dean Witter Asia Limited. These and other subsidiaries also conduct sales and trading activities worldwide, as principal and agent, and provide related financing services on behalf of institutional investors.

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### **Investment Banking.**

**Capital Raising.** Morgan Stanley manages and participates in public offerings and private placements of debt, equity and other securities worldwide. Morgan Stanley is a leading underwriter of common stock, preferred stock and other equity-related securities, including convertible securities and American Depositary Receipts ( ADRs ). Morgan Stanley is a leading underwriter of fixed income securities, including investment grade debt, non-investment grade instruments, mortgage-related and other asset-backed securities, tax-exempt securities and commercial paper and other short-term securities.

**Financial Advisory Services.** Morgan Stanley provides corporate and other institutional clients globally with advisory services on key strategic matters, such as mergers and acquisitions, divestitures, corporate defense strategies, joint ventures, privatizations, spin-offs, restructurings, proxy and consent solicitations, tender offers, exchange offers and leveraged buyouts. Morgan Stanley provides advice concerning recapitalizations, rights offerings, dividend policy, valuations, foreign exchange exposure, financial risk management strategies and financial planning. Morgan Stanley furnishes advice and services regarding project financings and provides advisory services in connection with the purchase, sale, leasing and financing of real estate.

**Corporate Lending.** Morgan Stanley provides to selected corporate clients through subsidiaries (including Morgan Stanley Bank) loans or lending commitments, including bridge financing. These loans and commitments have varying terms, may be senior or subordinated and/or secured or unsecured, are generally contingent upon representations, warranties and contractual conditions applicable to the borrower and may be syndicated, hedged or traded by Morgan Stanley.\* The borrowers may be rated investment grade or non-investment grade (as determined by Morgan Stanley's Institutional Credit Department using methodologies generally consistent with those employed by external rating agencies).

### **Sales, Trading, Financing and Market-Making Activities.\*\***

Morgan Stanley conducts sales, trading, financing and market-making activities on securities and futures exchanges and in over-the-counter ( OTC ) markets around the world. Morgan Stanley's combined management oversight of the Equity and Fixed Income divisions enhances the delivery of services to clients across asset classes.

### **Equity Securities and Related Products.**

**Core.** Morgan Stanley acts as principal (including as a market maker) and agent in executing transactions globally in equity and equity-related products, including common stock, ADRs, global depositary receipts and exchange-traded funds.

**Derivatives.** Morgan Stanley's equity derivatives sales, trading and market-making activities cover equity-related products globally, including equity swaps, options, warrants and futures overlying individual securities, indices and baskets of securities and other equity-related products. Morgan Stanley also issues and makes a principal market in equity-linked products to institutional and individual investors, including principal-protected securities.

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*Equity Financing Services.* Morgan Stanley provides equity financing services, including prime brokerage, which offers, among other services, consolidated clearance, settlement, custody, financing and portfolio reporting services to clients trading multiple asset classes. Morgan Stanley also engages in principal securities lending with clients, institutional lenders and other broker-dealers.

*Proprietary Trading.* Morgan Stanley engages in proprietary trading and investing activities utilizing several strategies and involving, among others, equity securities and derivative instruments related to equity securities.

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\* Revenues and expenses associated with the trading of syndicated loans are included in Sales, Trading, Financing and Market-Making Activities.

\*\* See also Risk Management in Part II, Item 7A for a description of Morgan Stanley's trading risk management structure, policies and procedures.

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### ***Fixed Income Securities and Related Products.***

***Credit Products.*** Morgan Stanley trades, makes markets and takes proprietary positions in fixed income securities and related products globally, including investment grade corporate debt, non-investment grade instruments, credit derivative products (including credit default swaps), distressed debt, bank loans, convertible bonds, preferred stock and commercial paper, money market and other short-term securities. Morgan Stanley originates, trades, makes markets and takes proprietary positions in, and acts as principal with respect to, mortgage-related and other asset-backed securities and real estate loan products. In December 2006, Morgan Stanley acquired Saxon Capital, Inc., a servicer and originator of subprime residential mortgage loans, and CityMortgage Bank, a leading Moscow based mortgage bank that specializes in originating, servicing and securitizing residential mortgage loans in the Russian Federation. Morgan Stanley also provides financing to customers for commercial and residential real estate loan products and other securitizable asset classes. Morgan Stanley advises on investment and liability strategies and assists corporations in their debt repurchases and tax planning. Morgan Stanley structures debt securities and derivatives with risk/return factors designed to suit client objectives, including using repackaged asset vehicles through which clients can restructure asset portfolios to provide liquidity or reconfigure risk profiles.

***Interest Rate and Currency Products.*** Morgan Stanley is a primary dealer of U.S. government securities and a member of the selling groups that distribute various U.S. agency and other debt securities. Morgan Stanley trades, makes markets and takes proprietary positions in interest rate, currency and other fixed income swaps and derivative products, OTC options on U.S. and non-U.S. government bonds and mortgage-backed forward agreements, options and swaps. Through the use of repurchase and reverse repurchase agreements, Morgan Stanley acts as an intermediary between borrowers and lenders of short-term funds and provides funding for various inventory positions. Morgan Stanley also trades fixed income futures. Through its triple-A rated subsidiary, Morgan Stanley Derivative Products Inc., Morgan Stanley enters into swaps and related derivative transactions with counterparties seeking a triple-A rated counterparty. Morgan Stanley also trades and makes markets in U.S. and non-U.S. government securities, municipal securities and emerging market securities. Morgan Stanley is a primary dealer or market-maker of government securities in numerous European, Asian and emerging market countries. Morgan Stanley is a market-maker in foreign currencies. Most of Morgan Stanley's foreign exchange business relates to major foreign currencies such as Yen, Euro, Sterling, Swiss francs and Canadian dollars. Morgan Stanley trades on a principal basis in the spot, forward, option and futures markets and takes proprietary positions in such currencies.

***Commodities.*** Morgan Stanley trades as principal and maintains proprietary trading positions in the spot, forward and futures markets in several commodities, including metals (base and precious), crude oil, oil products, natural gas, electric power, emission credits, coal and related products. In October 2006, Morgan Stanley announced its plans to invest approximately \$3 billion in carbon/emissions credits, projects and other initiatives related to greenhouse gas emissions reductions over the next five years. Morgan Stanley is a market-maker in exchange-traded options and futures and OTC options and swaps on commodities, and offers counterparties hedging programs relating to production, consumption, reserve/inventory management and structured transactions, including energy-contract securitizations. Morgan Stanley is an electricity power marketer in the U.S. and owns three electric generators in the U.S. and one in the Netherlands from which Morgan Stanley is the exclusive purchaser. On September 1, 2006, Morgan Stanley acquired TransMontaigne Inc. and its affiliates, a group of companies operating in the refined petroleum products marketing and distribution business, and the Heidmar Group of companies, which provide international marine transportation and U.S. marine logistics services.

### ***Other Activities.***

***Benchmark Indices and Risk Management Analytics.*** As of November 30, 2006, Morgan Stanley's majority-owned subsidiary, Morgan Stanley Capital International Inc. (MSCI), calculates and distributes over 40,000 international and U.S. equity benchmark indices (including the MSCI World and EAFE® Indices) covering over 55 countries, and has a 37-year historical database that includes fundamental and valuation data on thousands of equity securities in developed and emerging market countries. MSCI also calculates and distributes over 7,500 fixed income and over 190 hedge fund indices. MSCI's subsidiary, Barra, Inc., is a global leader in providing risk analytic tools and services to investors to help them analyze, measure and manage portfolio and firm-wide investment risk.



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**Research.** Morgan Stanley's global research department ( Research ) consists of economists, strategists and industry analysts. Research engages in equity and fixed income research activities and produces reports and studies on the U.S. and global economy, financial markets, portfolio strategy, technical market analyses, individual companies and industry developments. Research examines worldwide trends covering numerous industries and as of November 30, 2006 approximately 2,250 individual companies, the majority of which are located outside of the U.S. Research provides analysis and forecasts relating to economic and monetary developments that affect matters such as interest rates, foreign currencies, securities, derivatives and economic trends. Research provides analytical support and publishes reports on asset-backed securities and the markets in which such securities are traded. Research reports and data are disseminated to investors through third party distributors, proprietary internet sites such as Client Link and Morgan Stanley's sales forces.

**Investments.** Morgan Stanley from time to time makes investments that represent business facilitation or principal investing activities. Business facilitation investments are strategic investments undertaken by Morgan Stanley to facilitate core business activities. Principal investing activities are capital commitments provided to private companies, funds and other entities generally for proprietary purposes to maximize total returns to Morgan Stanley. Morgan Stanley expects to make additional principal investments over time. These principal investment activities are conducted within the investment banking and sales and trading areas in Institutional Securities.

Morgan Stanley sponsors and manages investment vehicles and separate accounts for clients seeking exposure to private equity, real estate-related and other alternative investments. Morgan Stanley may also invest in and provide capital to such investment vehicles. See also Asset Management.

## **Operations and Information Technology.**

Morgan Stanley's Operations and Information Technology departments provide the process and technology platform that supports Institutional Securities sales and trading activity, including post-execution trade processing and related internal controls over activity from trade entry through settlement and custody, including asset servicing. This is done for proprietary and customer transactions in listed and OTC transactions in commodities, equity and fixed income securities, including both primary and secondary trading, as well as listed, OTC and structured derivatives in markets around the world. This activity is undertaken through Morgan Stanley's own facilities as well as through membership in various clearing and settlement organizations globally.

## **Global Wealth Management Group.**

Morgan Stanley's Global Wealth Management Group business provides comprehensive financial services to clients spanning the wealth spectrum through a network of 8,030 global representatives with over 500 locations globally, including over 450 U.S. retail locations at fiscal year end. As of November 30, 2006, Morgan Stanley had \$686 billion in client assets. Morgan Stanley will merge its primary broker-dealer for Global Wealth Management Group, Morgan Stanley DW Inc. ( MSDWI ), into MS&Co. Upon completion of the merger, which Morgan Stanley currently anticipates to take place in April 2007, the surviving entity, MS&Co., will be Morgan Stanley's principal U.S. broker-dealer.

## **Clients.**

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Global Wealth Management Group professionals serve individual investors and small-to-medium size businesses and institutions with an emphasis on affluent and high net worth investors. In the U.S., products and services are delivered through several channels. Global Wealth Management Group's network of global representatives provide solutions designed to accommodate individual investment objectives, risk tolerance and liquidity needs for affluent and high net worth investors, and call centers are available to meet the needs of emerging affluent clients. Specialized Private Wealth Management investment representative teams provide sophisticated investment solutions and services for ultra high net worth individuals, families and foundations.

Outside the U.S., Morgan Stanley offers financial services to clients in Europe, the Middle East, Asia and Latin America. In addition to serving ultra high net worth clients throughout these regions, Morgan Stanley's international operations also include Morgan Stanley S.V., S.A. (Spain) and Morgan Stanley Gestión SGIIC,

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S.A., which provide investment advice and execution and discretionary investment management services, respectively, to individual investors in Spain. In December 2006, Morgan Stanley announced that it had reached an agreement to sell Quilter Holdings Ltd., its stand-alone U.K. mass affluent business.

### **Products and Services.**

Morgan Stanley's Global Wealth Management Group provides clients with a comprehensive array of financial solutions comprising Morgan Stanley's products and services, as well as products and services from third party providers, such as insurance companies and mutual fund families. Morgan Stanley offers brokerage and investment advisory services covering various investment alternatives, including equities, options, fixed income securities, mutual funds, structured products, alternative investments, unit investment trusts, managed futures, separately managed accounts and mutual fund asset allocation programs. Morgan Stanley also offers financial and wealth planning services, including education savings programs, as well as annuity and insurance products, including life, disability and long-term care insurance. Credit and other lending products are also available, including Morgan Stanley Home Loans, which provides residential mortgages and home equity lines of credit originated through Morgan Stanley's affiliated entities. Morgan Stanley's BusinessScape<sup>SM</sup> program offers cash management and commercial credit solutions to qualified small businesses in the U.S. Morgan Stanley offers banking and cash management services, including cash sweeps into bank deposits and money market funds, check writing, direct deposit, debit cards and business cash management. Morgan Stanley also provides retirement services, including defined contribution plans, 401(k) plans and stock plan administration to businesses of all sizes and trust and fiduciary services to individual and corporate clients. Global Wealth Management Group also provides clients with transactional services in futures, foreign currencies and precious metals.

Morgan Stanley's Global Wealth Management Group offers its clients a variety of ways to establish a relationship and conduct business to help meet their needs and preferences, including transaction-based pricing and asset-based fee pricing. The Active Assets Account<sup>®</sup> offers clients brokerage and banking services in one account. For clients who prefer fee-based pricing, Morgan Stanley Choice<sup>SM</sup> charges an asset-based fee in lieu of commissions. Clients can also choose to have a fee-based, separately managed account managed by affiliated or unaffiliated professional asset managers.

### **Operations and Information Technology.**

Morgan Stanley's Operations and Information Technology departments provide the process and technology platform that supports its Global Wealth Management Group activities from trade capture through clearance, settlement and custody, including asset servicing as well as bank deposit and loan processing through Morgan Stanley's affiliated banks. These activities are undertaken through Morgan Stanley's own facilities, through systems at computer centers operated by unaffiliated services providers and through memberships in various clearing corporations.

### **Asset Management.**

Morgan Stanley Investment Management is one of the largest global asset management organizations of any full-service securities firm and offers individual and institutional clients a diverse array of equity, fixed income, alternative investment and private equity strategies. Morgan Stanley had \$478 billion of assets under management or supervision as of November 30, 2006. Morgan Stanley's asset management activities are principally conducted under the Morgan Stanley and Van Kampen brands. Portfolio managers located in the U.S., Europe, Japan, Singapore and India manage investment products ranging from money market funds to equity, taxable and tax-exempt fixed income funds and alternative investment products in developed and emerging markets. Morgan Stanley offers clients various investment styles, such as value, growth, core, fixed income and asset allocation; global investments; active and passive management; and diversified and concentrated portfolios.



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Morgan Stanley offers a range of alternative investment products for institutional investors and high net worth individuals, including hedge funds, private equity funds, funds of hedge funds, funds of private equity funds and portable alpha overlays. Morgan Stanley typically acts as general partner of, and investment adviser to, its alternative investment funds and typically commits to invest a minority of the capital of such funds with subscribing investors contributing the majority. In 2006, Morgan Stanley completed an important phase in the

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build-out of its alternatives platform by purchasing FrontPoint Partners LLC, a leading provider of absolute return strategies with over \$5.5 billion in assets under management, and acquiring minority stakes in Lansdowne Partners and Avenue Capital Group.

### **Institutional Investors.**

Morgan Stanley provides asset management products and services to institutional investors worldwide, including pension plans, corporations, private funds, non-profit organizations, foundations, endowments, governmental agencies, insurance companies and banks. Products and services are available to institutional investors primarily through separate accounts, U.S. mutual funds and other pooled vehicles. Morgan Stanley Investment Management also sub-advises funds for various unaffiliated financial institutions and intermediaries. A global sales force and a team dedicated to covering the investment consultant industry serve institutional investors.

### **Individual Investors.**

Morgan Stanley offers open-end funds and separately managed accounts to individual investors through affiliated and unaffiliated broker-dealers, banks, insurance companies and financial planners. Closed-end funds managed by Morgan Stanley or Van Kampen are available to individual investors through affiliated and unaffiliated broker-dealers. A small number of unaffiliated broker-dealers account for a substantial portion of Van Kampen open-end fund sales. Morgan Stanley also sells Van Kampen funds through numerous retirement plan platforms. Internationally, Morgan Stanley distributes investment products to individuals outside the U.S. through non-proprietary distributors.

### **Operations and Information Technology.**

Morgan Stanley's Operations and Information Technology departments provide or oversee the process and technology platform required to support its asset management business. Support activities include transfer agency, mutual fund accounting and administration, transaction processing and certain fiduciary services, on behalf of institutional, retail and intermediary clients. These activities are undertaken either through its own facilities or through agreements with unaffiliated third parties.

### **Discover.\***

Based on its approximately 45.3 million general purpose credit card accounts at November 30, 2006, Morgan Stanley, through its Discover business, is one of the largest single issuers of general purpose credit cards in the U.S. Morgan Stanley's Discover business includes Discover Financial Services, which offers Discover-branded credit cards issued by Discover Bank and other consumer products and services; Discover Network, which operates a merchant and cash access network for Discover-branded cards; PULSE, an ATM/debit and electronic funds transfer network; and its Consumer Banking Group International in the U.K.

### **Credit Cards and Services.**

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Discover offers several types of general purpose credit and stored value cards that are designed to appeal to different market segments of consumers and businesses and that are accepted by merchants on the Discover Network. These card products include the Discover Platinum Card, the Discover Titanium Card, the Discover Business Card, the Discover Card with Pay-on-Time Bonus, the Miles Card from Discover and Discover pre-paid cards. Discover offers other consumer finance products and services and credit protection products. For example, Discover offers cardmembers certificates of deposit and money market accounts and the ability to transfer balances from other accounts or credit sources. In the U.K., Discover offers the Morgan Stanley Card, Goldfish-branded cards, the i24 Card, the Leeds Building Society Card, the Black Horse Card and the Morgan Stanley buy and fly! MasterCard on the MasterCard network and sells third party insurance and personal loan products. We are also a member of Visa Europe.

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\* See also Risk Management in Part II, Item 7A for a description of Morgan Stanley's interest rate and credit risk management structure, policies and procedures.

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Discover offers cardmembers other customer services. Pursuant to the Cashback Bonus<sup>®</sup> reward program, Discover provides certain cardmembers rewards based upon their level and type of purchases. Cardmembers may register their accounts online at [www.discovercard.com](http://www.discovercard.com), which offers cardmembers services such as timely e-mail reminders that help cardmembers avoid late payments, the capability to redeem Cashback Bonus rewards, make payments and view detailed account information. In addition, Discover offers cardmembers secure online account numbers that allow cardmembers to shop online without having to reveal their actual card number. As of November 30, 2006, Discover had over 16 million Discover cardmembers registered at [www.discovercard.com](http://www.discovercard.com).

## **Networks.**

Established in 1986, Discover Network is the largest proprietary credit card network in the U.S. Participants in the Discover Network accept Discover's general purpose credit cards and Discover Network cards. GE Money Bank issues two consumer credit cards, the Wal-Mart<sup>®</sup> Discover<sup>®</sup> and SAM'S CLUB<sup>®</sup> Discover<sup>®</sup> cards, on the Discover Network. Discover also has entered into agreements with several other financial institutions to issue cards on the Discover Network, including HSBC Bank Nevada, N.A. and CompuCredit Corporation. In 2006, Discover signed agreements with several companies, including First Data Corp., Global Payments Inc. and RBS Lynk to act as merchant acquirers for Discover Network and provide processing services for such merchants. Discover and China UnionPay have an agreement that enables China UnionPay cards to be accepted on the PULSE network in the U.S. and Discover Network cards to be accepted at China UnionPay ATMs and merchant locations in China. In fiscal 2006, Discover entered into an agreement with JCB, the largest card issuer in Japan, to facilitate acceptance of JCB cards on the Discover Network in the U.S. and of Discover Network cards on the JCB network in Japan.

Discover Network operates its network and acquiring businesses primarily in the U.S., provides customized programs to certain merchants in such areas as processing, and otherwise tailors program terms to meet merchant needs, either directly or through merchant acquirers. In addition to agreements with merchant acquirers, Discover Network also utilizes its own national sales and support force, independent sales agents and telemarketing force to maintain and increase its base among certain types of merchants.

Discover's business also includes PULSE, an ATM/debit and electronic funds transfer network. As of November 30, 2006, PULSE links cardholders of more than 4,400 financial institutions with almost 260,000 ATMs, as well as point-of-sale terminals located throughout the U.S. PULSE offers financial institutions a full-service debit platform and a complete product set, including signature debit and credit, PIN debit, gift card, stored value card and ATM services.

## **Operations and Information Technology.**

Discover performs the functions required to service and operate card accounts either by itself or through agreements with unaffiliated third parties. These functions include new account solicitation, application processing, new account fulfillment, transaction authorization and processing, cardmember billing, payment processing, fraud prevention and investigation, cardmember services, collection of delinquent accounts and other activities. Discover maintains several operations centers throughout the U.S. and one in Scotland. Systems at computer centers operated by an unaffiliated services provider also support the operations of Discover.

## **Competition.**

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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 and other 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 and broker-dealers, and with others on a regional or product basis. Morgan Stanley competes with commercial banks,

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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.

Over time, certain sectors of the financial services industry have become 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 our 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.

### **Discover.**

Credit cards issued by Discover compete 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, entertainment and financial advisory companies and debit cards. Credit cards issued on the Discover Network by third parties may also compete with credit cards offered by Discover. Competition centers on merchant acceptance of credit and debit cards (either directly or through merchant acquirers), account acquisition and customer utilization of credit and debit cards. Merchant acceptance is based on, among other factors, 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 fee levels, 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, MasterCard, Visa and American Express. The principal competitive factors that affect the network business include the number of merchants that accept cards, the number of cards in force and the amount of spending on these cards, the quantity

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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.

## **Regulation.**

Most aspects of Morgan Stanley's business are subject to stringent regulation by U.S. federal and state regulatory agencies and securities exchanges and by non-U.S. government agencies or regulatory bodies and securities exchanges. Aspects of Morgan Stanley's public disclosure, corporate governance principles, internal control environment and the roles of auditors and counsel are subject to the Sarbanes-Oxley Act of 2002 and related regulations and rules of the SEC and the NYSE.

New laws or regulations or changes to existing laws and regulations (including changes in the interpretation or enforcement thereof) either in the U.S. or elsewhere could materially adversely affect Morgan Stanley's financial condition or results of operations. As a global financial institution, to the extent that different regulatory regimes impose inconsistent or iterative requirements on the conduct of its business, Morgan Stanley faces complexity and additional costs in its compliance efforts.

## **Consolidated Supervision and Revised Capital Standards.**

Effective December 1, 2005, Morgan Stanley became a consolidated supervised entity (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. Morgan Stanley continues to work with its regulators on the implementation of the CSE rules and Basel II capital standards. As rules related to Basel II are released, Morgan Stanley will consult with regulators on the new requirements. Compliance with EU requirements (capital, oversight and reporting) will be a focus item through 2008.

## **Anti-Money Laundering.**

Morgan Stanley's Anti-Money Laundering (AML) program is coordinated and implemented on an enterprise-wide basis. In the U.S., for example, the USA PATRIOT Act of 2001 (the PATRIOT Act) imposes significant obligations to detect and deter money laundering and terrorist financing activity, including requiring banks, broker-dealers and mutual funds to identify and verify customers that maintain accounts. The PATRIOT Act also mandates that certain types of financial institutions report suspicious activity to appropriate law enforcement or regulatory authorities. An institution subject to the PATRIOT Act also must provide employees with AML training, designate an AML compliance officer and undergo an annual, independent audit to assess the effectiveness of its AML program. Outside the U.S., applicable laws and regulations subject designated types of financial institutions to similar AML requirements. Morgan Stanley has established policies, procedures and internal controls that are designed to comply with these AML requirements.

## **Protection of Client Information.**



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Many aspects of Morgan Stanley's business are subject to increasingly comprehensive legal requirements concerning the use and protection of certain client information including those adopted pursuant to the Gramm-Leach-Bliley Act of 1999 and the Fair and Accurate Credit Transactions Act of 2003 in the U.S., the European Union Data Protection Directive in the EU and various laws in Asia, including the Japanese Personal Information (Protection) Law, the Hong Kong Personal Data (Protection) Ordinance and the Australian Privacy Act. Morgan Stanley has adopted measures in response to such requirements.

### **Institutional Securities and Global Wealth Management Group.**

**Broker-Dealer Regulation.** MS&Co. and MSDWI are registered as broker-dealers with the SEC and in all 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands, and are members of self-regulatory organizations, including the National Association of Securities Dealers, Inc. (the NASD) and securities exchanges, including the NYSE. Broker-dealers are subject to laws and regulations covering all aspects of the securities business, including sales and trading practices, securities offerings, publication of research reports, use

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of customers' funds and securities, capital structure, record-keeping and retention and the conduct of their directors, officers, employees and other associated persons. Broker-dealers are also regulated by securities administrators in those states where they do business. Violations of the laws and regulations governing a broker-dealer's actions could result in censures, fines, the issuance of cease-and-desist orders, revocation of licenses or registrations, the suspension or expulsion from the securities industry of such broker-dealer or its officers or employees, or other similar consequences by both federal and state securities administrators.

Margin lending by broker-dealer subsidiaries is regulated by the Federal Reserve Board's restrictions on lending in connection with customer and proprietary purchases and short sales of securities, as well as securities borrowing and lending activities. Such subsidiaries are also required by NASD and NYSE rules to impose maintenance requirements on the value of securities contained in margin accounts. In many cases, Morgan Stanley's margin policies are more stringent than these rules.

Morgan Stanley conducts some of its government securities activities through Morgan Stanley Market Products Inc., a NASD member registered as a government securities broker-dealer with the SEC and in certain states. The Department of Treasury has promulgated regulations concerning, among other things, capital adequacy, custody and use of government securities and transfers and control of government securities subject to repurchase transactions. The rules of the Municipal Securities Rulemaking Board, which are enforced by the NASD, govern the municipal securities activities of Morgan Stanley.

As registered U.S. broker-dealers, certain subsidiaries of Morgan Stanley, including MS&Co. and MSDWI, are subject to the SEC's net capital rule and the net capital requirements of various securities exchanges. Many non-U.S. securities exchanges and regulatory authorities either have imposed or are proposing rules relating to capital requirements applicable to Morgan Stanley's non-U.S. broker-dealer subsidiaries. These rules, which specify minimum capital requirements, are generally designed to measure general financial integrity and liquidity and require that at least a minimum amount of net assets be kept in relatively liquid form. See also Consolidated Supervision and Revised Capital Standards above and Note 13 in Notes to Consolidated Financial Statements in Part II, Item 8. Rules of the NASD, NYSE, Chicago Mercantile Exchange and Chicago Board of Trade also impose limitations on the transfer of a broker-dealer's assets.

Compliance with the capital requirements may limit Morgan Stanley's operations requiring the intensive use of capital. Such requirements restrict Morgan Stanley's ability to withdraw capital from its broker-dealer subsidiaries, which in turn may limit its ability to pay dividends, repay debt or redeem or purchase shares of its own outstanding stock. Any change in such rules or the imposition of new rules affecting the scope, coverage, calculation or amount of capital requirements, or a significant operating loss or any unusually large charge against capital, could adversely affect Morgan Stanley's ability to pay dividends or to expand or maintain present business levels. In addition, such rules may require Morgan Stanley to make substantial capital infusions into one or more of its broker-dealer subsidiaries in order for such subsidiaries to comply with such rules, either in the form of cash or subordinated loans made in accordance with the requirements of the SEC's net capital rule.

***Regulation of Certain Commodities Activities.*** In connection with the commodities activities in the Institutional Securities business, Morgan Stanley engages in the production, storage, transportation, marketing and trading of several commodities, including metals (base and precious), crude oil, oil products, natural gas, electric power, emission credits, coal and related products. Morgan Stanley also conducts certain power generation and energy trading activities through Morgan Stanley Capital Group Inc. and/or entities in which Morgan Stanley is the sole or majority shareholder. These activities are subject to extensive and evolving energy, environmental and other governmental laws and regulations in the U.S. and abroad. In the past several years, intensified scrutiny of the energy markets by U.S. federal, state and local authorities in the U.S. and abroad and the public has resulted in increased regulatory and legal enforcement and remedial proceedings involving energy companies, including those engaged in power generation and liquid hydrocarbons trading. The EU has increased its focus on the energy markets which has resulted in increased regulation of companies participating in the energy markets, including those engaged in power generation and liquid hydrocarbons trading.



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Terminal facilities and other assets relating to Morgan Stanley's commodities activities are also subject to environmental laws both in the U.S. and abroad, including the U.S. Clean Air Act, which imposes obligations related to air emissions, and the U.S. Water Pollution Control Act, which regulates the discharge of wastewaters. In addition, pipeline, transport and terminal operations are also subject to the U.S. Comprehensive Environmental Response, Compensation and Liability Act, or the Superfund law, the Resource Conservation and Recovery Act and analogous state laws in connection with the cleanup of hazardous substances that may have been released at properties currently or previously owned or operated by us or locations to which we have sent wastes for disposal.

The workplaces associated with the transport, processing and storage facilities and pipelines Morgan Stanley or its subsidiaries own or operate are subject to the requirements of the federal Occupational Safety and Health Act, or OSHA, other federal statutes and comparable state statutes that regulate the protection of the health and safety of terminal and marine workers. In addition, the OSHA hazard communication standard requires the maintenance of information about hazardous materials used or produced in operations and that this information is provided to Morgan Stanley's employees, state and local government authorities and local residents. Failure to comply with OSHA requirements, including general industry standards, record keeping requirements and monitoring of occupational exposure to regulated substances, could result in significant fines or additional compliance costs.

***Additional Regulation of U.S. Entities.*** As registered futures commission merchants, MS&Co. and MSDWI are subject to the net capital requirements of, and their activities are regulated by, the Commodity Futures Trading Commission (the CFTC) and various commodity exchanges. Certain subsidiaries of Morgan Stanley are registered with the CFTC as commodity trading advisors and/or commodity pool operators. Morgan Stanley's futures and options-on-futures businesses are also regulated by the National Futures Association (the NFA), a registered futures association, of which MS&Co. and MSDWI and certain of their affiliates are members. Violations of the rules of the CFTC, the NFA or the commodity exchanges could result in remedial actions including fines, registration restrictions or terminations, trading prohibitions or revocations of commodity exchange memberships.

Morgan Stanley Bank, through which Morgan Stanley conducts certain financing and lending activities, is an industrial bank chartered under the laws of the State of Utah. It has deposits that are eligible for insurance by the Federal Deposit Insurance Corporation (FDIC) in accordance with FDIC rules and is subject to comprehensive regulation and periodic examination by the Utah Department of Financial Institutions and the FDIC. Morgan Stanley Bank is not considered a bank under the Bank Holding Company Act of 1956, as amended (the BHCA). See also Discover below.

Morgan Stanley Trust National Association, a wholly-owned subsidiary, is a federally chartered national bank whose activities are limited to fiduciary activities, primarily personal trust services. It is subject to comprehensive regulation and periodic examination by the Office of the Comptroller of the Currency. Morgan Stanley Trust National Association is not FDIC-insured and is not considered a bank for purposes of the BHCA.

***Non-U.S. Regulation.*** Morgan Stanley's businesses are also regulated extensively by non-U.S. regulators, including governments, securities exchanges, commodity exchanges, self-regulatory organizations, central banks and regulatory bodies, especially in those jurisdictions in which Morgan Stanley maintains an office. As Morgan Stanley continues to expand its business internationally, including in such countries as China, Dubai, Italy, Korea, Russia, Turkey and Qatar, it will become subject to regulation in the jurisdictions in which it conducts business. Certain Morgan Stanley subsidiaries are regulated as broker-dealers under the laws of the jurisdictions in which they operate. Subsidiaries engaged in banking and trust activities outside the U.S. are regulated by various government agencies in the particular jurisdiction where they are chartered, incorporated and/or conduct their business activity. For instance, the Financial Services Authority, the London Stock Exchange and Euronext.liffe regulate the Company's activities in the U.K.; the Deutsche Borse AG and the Bundesanstalt für Finanzdienstleistungsaufsicht (the Federal Financial Supervisory Authority) regulate its activities in the Federal Republic of Germany; the Swiss Federal Banking Commission regulates its activities in Switzerland; the Comisión Nacional del Mercado de Valores (C.N.M.V.) regulates its activities in Spain; the Financial Services Agency, the Bank of Japan, the Japanese Securities Dealers Association and several Japanese securities and futures exchanges, including the Tokyo Stock Exchange, the Osaka Securities Exchange and the Tokyo International Financial Futures Exchange, regulate its



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activities in Japan; the Hong Kong Securities and Futures Commission, the Stock Exchange of Hong Kong Limited and the Hong Kong Futures Exchange Limited regulate its operations in Hong Kong; and the Monetary Authority of Singapore and the Singapore Exchange Securities Trading Limited regulate its business in Singapore.

The EU's European Markets in Financial Instruments Directive (Directive 2004/39/EC, the Directive) will affect several of Morgan Stanley's European subsidiaries by imposing detailed pan-European requirements in areas such as internal organization (including conflict management), best execution, real-time disclosure of completed transactions in shares, quoting obligations for internalized client orders in shares, transaction reporting to regulators, client documentation and regulation of investment services related to commodity derivatives. The practical consequences of some of these changes on the European markets are becoming clearer as the Directive is implemented into the national legislation.

**Research.** Both U.S. and non-U.S. regulators continue to focus on research conflicts of interest. Research-related regulations have been implemented in many jurisdictions and are proposed or under consideration in other jurisdictions. New and revised requirements resulting from these regulations and the global research settlement with U.S. Federal and state regulators (to which Morgan Stanley is a party) have necessitated the development or enhancement of corresponding policies and procedures.

### **Asset Management.**

The majority of subsidiaries related to Morgan Stanley's asset management activities and others, including MS&Co. and MSDWI, are registered as investment advisers with the SEC, and, in certain states, some employees or representatives of subsidiaries are registered as investment adviser representatives. Many aspects of Morgan Stanley's asset management activities are subject to federal and state laws and regulations primarily intended to benefit the investor or client. These laws and regulations generally grant supervisory agencies and bodies broad administrative powers, including the power to limit or restrict Morgan Stanley from carrying on its asset management activities in the event that it fails to comply with such laws and regulations. Sanctions that may be imposed for such failure include the suspension of individual employees, limitations on Morgan Stanley engaging in various asset management activities for specified periods of time, the revocation of registrations, other censures and fines.

Morgan Stanley's Asset Management business is also regulated outside the U.S. For example, the Financial Services Authority regulates Morgan Stanley's business in the U.K.; the Financial Services Agency regulates Morgan Stanley's business in Japan; the Securities and Exchange Board of India regulates Morgan Stanley's business in India; and the Monetary Authority of Singapore regulates Morgan Stanley's business in Singapore.

Morgan Stanley Trust, a wholly-owned subsidiary, is a federally chartered savings bank subject to comprehensive regulation and periodic examination by the Office of Thrift Supervision (OTS). As a result of its ownership of Morgan Stanley Trust, Morgan Stanley is registered with the OTS as a unitary savings and loan holding company (SLHC) and subject to regulation and examination by the OTS as a SLHC. Subsidiaries of Morgan Stanley, including Morgan Stanley Trust, are registered transfer agents subject to regulation and examination by the SEC.

### **Discover.**

Morgan Stanley conducts substantial portions of its Discover business in the U.S. through its wholly-owned indirect subsidiary, Discover Bank, a Delaware chartered state bank. Discover Bank's deposits are eligible for insurance by the FDIC in accordance with FDIC rules and Discover

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Bank is subject to comprehensive regulation and periodic examination by the Office of the Delaware Bank Commissioner and by the FDIC.

Generally, a company that controls a bank, as defined in the BHCA, is required to register as a bank holding company and is regulated as a bank holding company by the Board of Governors of the Federal Reserve System. Discover Bank is considered a bank under the BHCA; however, under the BHCA, Morgan Stanley's control of Discover Bank is grandfathered and Morgan Stanley is generally not treated as a bank holding company for purposes of the BHCA as long as Discover Bank refrains from either engaging in commercial lending or taking demand deposits.

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Federal and state consumer protection laws and regulations regulate extensively the relationships among cardholders and credit card issuers. Under federal law, Discover Bank may charge interest at the rate allowed by Delaware law, the state in which it is located, and export such interest rate to all other states. Delaware law does not limit the amount of interest that may be charged on loans of the type offered by Discover Bank. Federal and state bankruptcy laws, debtor relief laws and bank regulatory guidance may have a financial impact on Discover to the extent such laws or guidance result in any loans being charged off as uncollectible.

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ( FDICIA ), the federal bank regulatory agencies are required to take prompt corrective action in respect of banks that do not meet minimum capital requirements, and certain restrictions are imposed upon banks that meet certain capital requirements but are not well capitalized for purposes of FDICIA. A bank that is not well capitalized, as defined for purposes of FDICIA, is, among other consequences, generally prohibited from accepting brokered deposits and offering interest rates on any deposits significantly higher than the prevailing rate in its normal market area or nationally (depending upon where the deposits are solicited). Discover Bank and Morgan Stanley Bank currently use brokered deposits as a funding source and, if they were not able to do so, their funding costs could be impacted.

Discover conducts its U.K. credit card business through Morgan Stanley Bank International Limited, Morgan Stanley's chartered bank in the U.K., which is subject to regulation related to capital adequacy, consumer protection and deposit protection. The bank is governed primarily by the U.K.'s Financial Services and Markets Act 2000 and its activities are supervised by the Financial Services Authority and by the Office of Fair Trading in relation to its consumer credit activities.

## **Executive Officers of Morgan Stanley.**

The executive officers of Morgan Stanley and their ages and titles as of February 12, 2007 are set forth below. Business experience for the past five years is provided in accordance with SEC rules.

**John J. Mack (62).** Chairman of the Board of Directors and Chief Executive Officer (since June 2005). Chairman of Pequot Capital Management (June 2005). Co-Chief Executive Officer of Credit Suisse Group (January 2003 to June 2004). President, Chief Executive Officer and Director of Credit Suisse First Boston (July 2001 to June 2004). President and Chief Operating Officer of Morgan Stanley (May 1997 to March 2001).

**Zoe Cruz (52).** Co-President (since February 2006 and March 2005 to July 2005). Acting President (July 2005 to February 2006). Director (March 2005 to June 2005). Head of Fixed Income Division (September 2000 to March 2005).

**Robert W. Scully (57).** Co-President (since February 2006). Chairman of Global Capital Markets (December 2004 to February 2006) and Vice Chairman of Investment Banking (September 1999 to February 2006). Director of GMAC LLC (since November 2006).

**Gary G. Lynch (56).** Chief Legal Officer (since October 2005). Global General Counsel (October 2001 to October 2005) of Credit Suisse First Boston. Vice Chairman (December 2002 to July 2004) and Executive Vice Chairman (July 2004 to October 2005) of Credit Suisse First Boston. Partner at the law firm of Davis Polk & Wardwell (September 1989 to October 2001).



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**Eileen K. Murray (48).** Head of Global Operations and Technology (since October 2005). Head of Global Technology and Operations of Credit Suisse First Boston (February 2002 to July 2005). Chief Administrative Officer of Institutional Securities of Morgan Stanley (March 1999 to January 2002).

**Thomas R. Nides (45).** Executive Vice President, Chief Administrative Officer and Secretary (since September 2005). Worldwide President and CEO of Burson-Marsteller (November 2004 to August 2005). Chief Administrative Officer of Credit Suisse First Boston (June 2001 to June 2004).

**David H. Sidwell (53).** Executive Vice President and Chief Financial Officer (since March 2004). Chief Financial Officer of the investment bank of J.P. Morgan Chase & Co. (December 2000 to March 2004).

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**Item 1A. Risk Factors.**

**Liquidity Risk.**

Liquidity and funding risk refers to the risk that Morgan Stanley will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity and funding risk also encompasses the ability of Morgan Stanley to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten its viability as a going concern. For more information on how we monitor and manage liquidity and funding risk, see Management's Discussion and Analysis of Results of Operations—Liquidity and Capital Resources in Part II, Item 7 below.

*Liquidity is essential to our businesses and we rely on external sources to finance a significant portion of our operations.*

Liquidity is essential to our businesses. Our 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 we cannot control, such as disruption of the financial markets or negative views about the financial services industry generally, could impair our ability to raise funding. In addition, our ability to raise funding could be impaired if lenders develop a negative perception of our long-term or short-term financial prospects. Such negative perceptions could be developed if we incur large trading losses, we are downgraded or put on negative watch by the rating agencies, we suffer a decline in the level of our business activity, regulatory authorities take significant action against us, or we discover serious employee misconduct or illegal activity, among other reasons. If we are unable to raise funding using the methods described above, we would likely need to liquidate unencumbered assets, such as our investment and trading portfolios, to meet maturing liabilities. We may be unable to sell some of our assets, or we may have to sell assets at a discount from market value, either of which could adversely affect our results of operations.

*Our borrowing costs and access to the debt capital markets depend significantly on our credit ratings.*

The cost and availability of unsecured financing generally are dependent on our short-term and long-term credit ratings. Factors that are significant to the determination of our credit ratings or otherwise affect our ability to raise short-term and long-term financing include the level and volatility of our earnings; our relative competitive position in the markets in which we operate; our geographic and product diversification; our ability to retain key personnel; our risk profile; our risk management policies; our cash liquidity; our capital adequacy; our 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 our credit ratings, thereby increasing our cost of obtaining unsecured funding.

Our 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, we 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.

*We are a holding company and depend on payments from our subsidiaries.*

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We depend on dividends, distributions and other payments from our subsidiaries to fund dividend payments and to fund all payments on our obligations, including debt obligations. Regulatory and other legal restrictions may limit our ability to transfer funds freely, either to or from our subsidiaries. In particular, many of our subsidiaries, including our 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 our ability to access funds that we may need to make payments on our obligations.

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*If our liquidity and funding policies are not adequate, we may be unable to access sufficient financing.*

Our liquidity and funding policies have been designed to ensure that we maintain sufficient liquid financial resources to continue to conduct our business for an extended period in a stressed liquidity environment. If our liquidity and funding policies are not adequate or we do not adhere to the policies, we may be unable to access sufficient financing to service our financial obligations when they come due, which could have a material adverse franchise or business impact.

### **Market Risk.**

Market risk refers to the risk that a change in the level of one or more market prices of commodities or securities, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as liquidity, will result in losses for a position or portfolio. For more information on how we monitor and manage market risk, see **Market Risk** in Part II, Item 7A below.

*Our results of operations may be materially affected by market fluctuations and by economic and other factors.*

The amount, duration and range of our market risk exposures have been increasing over the past several years, and may continue to do so. Our results of operations may be materially affected by market fluctuations due to economic 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 liquidity of global markets; 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 our businesses that potentially could increase costs, thereby affecting future results of operations. These factors also may have an impact on our ability to achieve our strategic objectives.

The results of our Institutional Securities business, particularly results relating to our involvement in primary and secondary markets for all types of financial products, are subject to substantial fluctuations due to a variety of factors, such as those enumerated above that we cannot control or predict with great certainty. These fluctuations impact results by causing variations in new business flows and in the fair value of securities and other financial products. 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 our 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 our Global Wealth Management Group business. In addition, fluctuations in global market activity could impact the flow of investment capital into or from assets under management or supervision and the way customers allocate capital among money market, equity, fixed income or other investment alternatives, which could negatively impact our Asset 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 our Discover business.

*Holding large and concentrated positions may expose us to losses.*

Concentration of risk may reduce revenues or result in losses in our market-making, proprietary trading, investing, block trading, underwriting and lending businesses in the event of unfavorable market movements. We have committed substantial amounts of capital to these businesses, which often require us to take large positions in the securities of, or make large loans to, a particular issuer or issuers in a particular industry, country or region. Moreover, the trend in all major capital markets is towards larger and more frequent commitments of capital in many of these activities, and we expect this trend to continue.

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*The profitability of certain of our commodities marketing activities depends on the availability of supplies of petroleum products. A significant decrease in available supplies for any reason could adversely affect the sales and results of operations of certain businesses within our commodities activities.*

The success of our marketing and distribution in our commodities business depends on our ability to generate positive margins on sales of refined petroleum products. In addition, our terminal, tug and barge business depends on an active market for refined petroleum products to create demand for terminal services. The availability of supplies of refined petroleum products is essential to our pipeline, transport and terminal operations. A material disruption in the flow of refined petroleum product supplies could adversely affect our revenues from rack spot and contract sales, as well as throughput and storage fees. Among such risks are force majeure conditions caused by natural disasters, adverse weather conditions, terrorist attacks and other events beyond our control. These conditions also may adversely affect the pipeline and marine operations as well as the shipping and terminaling operations in our commodities business.

*We may incur significant losses in the real estate sector.*

We finance and acquire principal positions in a number of real estate and real estate-related products for our own account, for investment vehicles managed by affiliates in which we also may have a significant investment, for separate accounts managed by affiliates and for major participants in the commercial and residential real estate markets, and originate loans secured by commercial and residential properties. We also securitize and trade in a wide range of commercial and residential real estate and real estate-related whole loans, mortgages and other real estate and commercial assets and products, including residential and commercial mortgage-backed securities. These businesses could be adversely affected by a downturn in the real estate sector.

### **Credit Risk.**

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 us. We are exposed to three distinct types of credit risk in our businesses. For more information on how we monitor and manage credit risk, see **Credit Risk** in Part II, Item 7A below.

*We are exposed to the risk that third parties that are indebted to us will not perform their obligations.*

We incur 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 us and by extending credit to our clients through various credit arrangements. We incur 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. We incur 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 our credit exposures have been increasing over the past several years, and may continue to do so. In recent years, we have significantly expanded our use of swaps and other derivatives and we may continue to do so. Corporate clients are increasingly seeking loans or lending commitments from us in connection with investment banking and other assignments. In addition, we have experienced, due to competitive factors, increased pressure to assume longer-term credit risk, to extend credit against less liquid collateral and to price

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derivatives instruments more aggressively based on the credit risks that we take. As a clearing member firm, we finance our customer positions and we could be held responsible for the defaults or misconduct of our customers. Although we regularly review our credit exposures, default risk may arise from events or circumstances that are difficult to detect or foresee.

*Defaults by another larger financial institution could adversely affect financial markets generally.*

The commercial soundness of many financial institutions may be closely interrelated as a result of credit, trading, clearing or other relationships between the institutions. As a result, concerns about, or a default or threatened

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default by, one institution could lead to significant market-wide liquidity problems, losses or defaults by other institutions. This is sometimes referred to as systemic risk and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges, with which we interact on a daily basis, and therefore could adversely affect Morgan Stanley.

### **Operational Risk.**

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.). Morgan Stanley may incur operational risk across its full scope of business activities, including revenue generating activities (e.g. sales and trading) and support functions (e.g. information technology and facilities management). As such, Morgan Stanley may incur operational risk in each of its businesses, as well as within the control groups. For more information on how we monitor and manage operational risk, see **Operational Risk** in Part II, Item 7A below.

*We are subject to operational risk and an operational event could adversely affect our businesses.*

Our businesses are highly dependent on our ability to process, on a daily basis, a large number of transactions across numerous and diverse markets in many currencies. In general, the transactions we process are increasingly complex. We perform the functions required to operate our different businesses either by ourselves or through agreements with third parties. We rely on the ability of our employees, our internal systems and systems at technology centers operated by third parties to process a high volume of transactions. We also face the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries we use to facilitate our securities transactions. In the event of a breakdown or improper operation of our or third party's systems or improper action by third parties or employees, we could suffer financial loss, an impairment to our liquidity, a disruption of our businesses, regulatory sanctions or damage to our reputation.

Despite the business contingency plans we have in place, our ability to conduct business may be adversely affected by a disruption in the infrastructure that supports our business and the communities where we are located. This may include a disruption involving physical site access, terrorist activities, disease pandemics, electrical, communications or other services used by Morgan Stanley, its employees or third parties with whom we conduct business.

### **Legal Risk.**

Legal risk refers to the risk of non-compliance with applicable legal and regulatory requirements and standards. Legal risk also includes contractual and commercial risk such as the risk that a counterparty's performance obligations will be unenforceable. For more information on how we monitor and manage legal risk, see **Legal Risk** in Part II, Item 7A below.

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



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We have been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions, and other litigation, arising in connection with our 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.

We are also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding our business, including, among other things, 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 us. Like any large corporation, we are also subject to risk from potential employee misconduct, including non-compliance with policies and improper use or disclosure

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of confidential information. Substantial legal liability or significant regulatory action against us could materially adversely affect our business, financial condition or results of operations or cause us significant reputational harm, which could seriously harm our business. For more information regarding legal proceedings in which we are involved and in particular, the *Coleman Litigation*, see Legal Proceedings in Part I, Item 3 below.

### ***We are subject to extensive regulation in the jurisdictions in which we conduct our businesses.***

We are subject to extensive regulation globally and face the risk of significant intervention by regulatory authorities in the jurisdictions in which we conduct our businesses. Among other things, we could be fined, prohibited from engaging in some of our business activities or subject to limitations or conditions on our business activities. Significant regulatory action against us could have material adverse financial effects, cause significant reputational harm to us, or harm our business prospects. New laws or regulations or changes in the enforcement of existing laws or regulations applicable to our clients may also adversely affect our business. For more information regarding the regulatory environment in which we operate, see Regulation in Part I, Item 1 above.

### ***Our commodities activities subject us to extensive regulation, potential catastrophic events and environmental risks and regulation that may expose us to significant costs and liabilities.***

In connection with the commodities activities in our Institutional Securities business, we engage in the production, storage, transportation, marketing and trading of several commodities, including metals (base and precious), crude oil, oil products, natural gas, electric power, emission credits, coal and related products. In addition, we own three exempt wholesale generators in the U.S. and one electric generation facility in the Netherlands. As a result of these activities, we are subject to extensive and evolving energy, environmental, safety and other governmental laws and regulations. Our commodities business also exposes us to the risk of unforeseen and catastrophic events, including leaks, spills and terrorist attacks.

Although we have attempted to mitigate our pollution and other environmental risks, including those discussed below, 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, if any, from insurance recovery may not be adequate to cover liabilities with respect to particular incidents. As a result, our financial condition and results of operations may be adversely affected by these events.

We also expect the other laws and regulations affecting our 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 we are engaged. We may incur substantial costs in complying with current or future laws and regulations and our overall businesses and reputation may be adversely affected by the current legal environment.

*Pipeline, Marine Transport and Terminal Operations.* The risk of substantial environmental costs and liabilities is inherent in pipeline, marine transport and terminal operations. As is the case with respect to our other commodities activities, both U.S. and international environmental laws are or may be applicable, including U.S. and foreign oil spill anti-pollution statutes. Liability may be incurred without regard to fault under federal laws and regulations and analogous state laws for the remediation of contaminated areas.

Prior owners, tenants or users of properties now owned by us or our subsidiaries may have disposed of or released hydrocarbons or solid wastes on or under such assets. Additionally, the acquired pipeline, transport and terminal operations are located near current or former refining and terminal operations. There is a risk that contamination, if ever present, has migrated or could migrate from those properties. Increasingly strict environmental laws, regulations and enforcement policies and claims for damages and other similar developments could result in substantial costs and liabilities.

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Certain operations in our commodities business are subject to the hazards inherent in the transportation and storage of volatile and sometimes toxic petroleum products, including explosions, the release of toxic substances, fires and accidents on land and at sea that could result in personal injuries, loss of life and suspension of operations. These operations also are subject to risks associated with natural disasters, adverse weather conditions, terrorist attacks and other events beyond our control. Although we maintain substantial insurance coverage, catastrophic events of this kind could exceed such coverage.

*Power Generation Facilities.* The power generation facilities we own 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.

*Oil Trading Activities.* The U.S. and foreign water pollution laws and numerous specific oil spill anti-pollution statutes apply to our oil trading activities to the extent we own petroleum in storage or during waterborne or overland transit or we arrange for transportation or storage. In the event of an oil spill, one or more entities we own 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 we blend and import and provide for substantial penalties in the event of non-compliance. Oil pollution laws in non-U.S. jurisdictions also apply to us in certain instances when we trade 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.

*Conflicts of interest are increasing and a failure to appropriately deal with conflicts of interest could adversely affect our businesses.*

Our reputation is one of our most important assets. As we have expanded the scope of our businesses and our client base, we increasingly have to address potential conflicts of interest, including those relating to our proprietary activities. For example, conflicts may arise between our position as a financial advisor in a merger transaction and a principal investment we hold in one of the parties to the transaction. In addition, hedge funds and private equity funds are an increasingly important portion of our client base, and also compete with us in a number of our businesses. We have procedures and controls that are designed to address conflicts of interest. However, appropriately dealing with conflicts of interest is complex and difficult and our reputation could be damaged if we fail, or appear to fail, to deal appropriately with conflicts of interest. In addition, the SEC 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 our clients less willing to enter into transactions in which such a conflict may occur, and will adversely affect our businesses.

*We are subject to tax contingencies that could adversely affect results.*

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



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### **Competitive Environment.**

*We face strong competition from other financial services firms, which could lead to pricing pressures that could materially adversely affect our revenue and profitability.*

The financial services industry, and all of our businesses, are intensely competitive, and we expect them to remain so. We compete 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. We compete on the basis of several factors, including transaction execution, capital or access to capital, 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 our competitors gaining greater capital and other resources, such as a broader range of products and services and geographic diversity. We may experience pricing pressures as a result of these factors and as some of our competitors seek to increase market share by reducing prices. For more information regarding the competitive environment in which we operate, see Competition in Part I, Item 1 above.

*Our ability to retain and attract qualified employees is critical to the success of our business and the failure to do so may materially adversely affect our performance.*

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

### **International Risk.**

*We are subject to numerous political, economic, legal, operational and other risks as a result of our international operations which could adversely impact our businesses in many ways.*

We are 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 us to determine the exact requirements of local laws in every market. Our inability to remain in compliance with local laws in a particular market could have a significant and negative effect not only on our businesses in that market but also on our reputation generally. We are also subject to the enhanced risk that transactions we structure might not be legally enforceable in all cases.

We have expanded, and continue to look at opportunities to expand, in the emerging markets. 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 our 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 our ability to manage our businesses around the world.

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### **Acquisition Risk.**

*We may be unable to fully capture the expected value from future acquisitions, joint ventures and minority stakes.*

We expect to grow in part through acquisitions, joint ventures and minority stakes. To the extent we make acquisitions or enter into combinations or joint ventures, we face 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 and minority stakes, we are subject to additional risks and uncertainties in that we may be dependent upon, and subject to liability, losses or reputational damage relating to, systems, controls and personnel that are not under our control. In addition, conflicts or disagreements between us and our joint venture partners may negatively impact the benefits to be achieved by the joint venture. There is no assurance that our recent acquisitions or any business we acquire in the future will be successfully integrated and result in all of the positive benefits anticipated. If we are not able to integrate successfully our past and future acquisitions, there is a risk that our results of operations may be materially and adversely affected.

### **Credit Card Risk.**

*Our Discover business subjects us to risks that impact the credit card industry.*

The performance of our 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, consumer spending and consumer debt may substantially affect consumer loan levels and credit quality. Our financial condition and results of operations may be adversely affected by these factors.

### **Risk Management.**

*Our hedging strategies and other risk management techniques may not be fully effective in mitigating our risk exposure in all market environments or against all types of risk.*

We have devoted significant resources to develop our risk management policies and procedures and expect to continue to do so in the future. Nonetheless, our hedging strategies and other risk management techniques may not be fully effective in mitigating our risk exposure in all market environments or against all types of risk, including risks that are unidentified or unanticipated. Some of our methods of managing risk are based upon our use of observed historical market behavior. As a result, these methods may not predict future risk exposures, which could be significantly greater than the historical measures indicate. Management of operational, legal and regulatory risks requires, among other things, policies and procedures to record properly and verify a large number of transactions and events, and these policies and procedures may not be fully effective. For more information on how we monitor and manage market risk, see **Market Risk** in Part II, Item 7A below.



**Item 1B. Unresolved Staff Comments.**

Morgan Stanley, like other well-known seasoned issuers, from time to time receives written comments from the staff of the SEC regarding its periodic or current reports under the Exchange Act. There are no comments that remain unresolved that Morgan Stanley received not less than 180 days before the end of its fiscal year to which this report relates that Morgan Stanley believes are material.

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Morgan Stanley has offices, operations and processing centers and warehouse facilities located throughout the U.S., and certain subsidiaries maintain offices and other facilities in international locations. Morgan Stanley's properties that are not owned are leased on terms and for durations that are reflective of commercial standards in the communities where these properties are located. Morgan Stanley believes the facilities it owns or occupies are adequate for the purposes for which they are currently used and are well maintained. Our principal offices consist of the following properties:

Location	Owned/ Leased	Lease Expiration	Approximate Square Footage as of November 30, 2006*
<b>U.S. Locations</b>			
1585 Broadway New York, New York <i>(Executive Office)</i>	Owned	N/A	894,000 square feet
522 Fifth Avenue New York, New York <i>(Asset Management Headquarters)</i>	Leased	2021	580,000 square feet**
2000 Westchester Avenue Purchase, New York <i>(Global Wealth Management Group Headquarters)</i>	Owned	N/A	570,000 square feet
2500 Lake Cook Road Riverwoods, Illinois <i>(Discover Executive Office)</i>	Owned	N/A	1,200,000 square feet
New York, New York	Leased	2007 2018	2,605,000 square feet
Brooklyn, New York	Leased	2013	457,000 square feet
Jersey City, New Jersey	Leased	2008 2013	499,000 square feet
<b>International Locations</b>			
25 Cabot Square, Canary Wharf <i>(London Headquarters)</i>	Owned***	N/A	455,000 square feet

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Canary Wharf	Leased	2007 - 2038	970,000 square feet
Sapporo s Yebisu Garden Place, Ebisu, Shibuya-ku <i>(Tokyo Headquarters)</i>	Leased	Option to cancel in 2007, or at any time thereafter	307,000 square feet

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\* The indicated total aggregate square footage leased does not include space occupied by Morgan Stanley securities branch offices.

\*\* The landlord of this location is a joint venture in which Morgan Stanley has a majority interest. Morgan Stanley has the right to purchase the remainder of the interest in the joint venture in fiscal 2007.

\*\*\* Morgan Stanley holds the freehold interest in the land and building.

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**Item 3. Legal Proceedings.**

In addition to the matters described below, in the normal course of business, 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 Morgan Stanley'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 Morgan Stanley.

Morgan Stanley contests liability and/or the amount of damages as appropriate in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, Morgan Stanley cannot predict with certainty the loss or range of loss, if any, related to such matters, how or if such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief, if any, might be. Subject to the foregoing, and except for the *Coleman Litigation* (see also Note 9 in Notes to Consolidated Financial Statements in Part II, Item 8), Morgan Stanley believes, based on current knowledge and after consultation with counsel, that the outcome of all other pending matters will not have a material adverse effect on the consolidated financial condition of Morgan Stanley, although the outcome of such matters could be material to Morgan Stanley's operating results for a particular future period, depending on, among other things, the level of Morgan Stanley's revenues or income for such period.

**Coleman Litigation.**

On May 8, 2003, Coleman (Parent) Holdings Inc. (CPH) filed a complaint against Morgan Stanley in the Circuit Court of the Fifteenth Judicial Circuit for Palm Beach County, Florida. The complaint relates to the 1998 merger between The Coleman Company, Inc. (Coleman) and Sunbeam, Inc. (Sunbeam). 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 Morgan Stanley 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 Morgan Stanley and ordered that portions of CPH's complaint, including those setting forth CPH's primary allegations against Morgan Stanley, 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, Morgan Stanley filed a notice of appeal with the District Court of Appeal for the Fourth District of Florida (the Court of Appeal) and posted a supersedeas bond, which automatically stayed execution of the judgment pending appeal. Morgan Stanley filed its initial brief in support of its appeal on December 7, 2005 and, on June 28, 2006, the Court of Appeal heard oral argument. Morgan Stanley'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 Morgan Stanley or, in the alternative, for a new trial.

**IPO Fee Litigation.**

Starting in late 1998, purported class actions, later captioned *In re Public Offering Fee Antitrust Litigation* (the purchaser actions ) and *In re Issuer Plaintiff Initial Public Offering Fee Antitrust Litigation* (the issuer

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actions ), were initiated in the U.S. District Court for the Southern District of New York (the SDNY ) against Morgan Stanley and numerous other underwriters. The consolidated proceedings, one on behalf of purchasers and the other on behalf of issuers of certain shares in initial public offerings ( IPOs ), allege that defendants conspired to fix the underwriters' spread at 7% in IPOs of U.S. companies in the \$20 million to \$80 million range in violation of Section 1 of the Sherman Act. The complaints seek treble damages and injunctive relief. Plaintiffs' claims for damages in the purchaser actions have been dismissed, but the claims for injunctive relief remain. Plaintiffs' claims for damages and injunctive relief remain in the issuer actions. Plaintiffs moved for class certification in both actions, and defendants opposed that motion on May 25, 2005. On October 25, 2005, plaintiffs moved for summary judgment, which defendants opposed. On April 18, 2006, the court denied plaintiffs' motion for class certification in the issuer actions. 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, and on August 1, 2006, the U.S. Court of Appeals for the Second Circuit (the Second Circuit ) granted plaintiffs' petition. The case is otherwise stayed pending the appeal on class certification.

**IPO Allocation Matters.**

In March 2001, a purported class action, now captioned *In re Initial Public Offering Antitrust Litigation*, was initiated in the SDNY against Morgan Stanley and numerous other underwriters of various IPOs. The consolidated amended complaint alleges that defendants required customers who 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 ( "tie-in purchases" ) at escalating price levels higher than the IPO price (a practice plaintiffs refer to as "laddering" ). The complaint alleges violations of federal and/or state antitrust laws, including Section 1 of the Sherman Act. On September 28, 2005, the Second Circuit reversed the district court's dismissal of this matter. On January 12, 2006, the Second Circuit denied defendants' petition for rehearing *en banc*. On March 8, 2006, defendants filed a petition to the U.S. Supreme Court for writ of certiorari, which was granted on December 7, 2006.

Also beginning in March 2001, numerous purported class actions, now captioned *In re Initial Public Offering Securities Litigation*, were filed in the SDNY against certain issuers of IPO securities, certain individual officers of those issuers, Morgan Stanley and other underwriters of those IPOs, purportedly on behalf of purchasers of stock in the IPOs or the aftermarket. These complaints make factual allegations similar to the complaint in the antitrust action described above, but claim violations of the federal securities laws, including Sections 11 and 12(a)(2) of the Securities Act of 1933 (the Securities Act ) and Section 10(b) of the Exchange Act. 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. On February 19, 2003, the underwriter defendants' joint motion to dismiss was denied, except as to certain specified offerings. On December 5, 2006, the Second Circuit reversed the SDNY's grant of class certification, and ruled that these cases could not be certified for class treatment. On January 5, 2007, plaintiffs filed a petition for rehearing and rehearing *en banc*.

On June 10, 2004, plaintiffs and issuer defendants entered into a definitive settlement agreement under which insurers of the issuers would guarantee recovery of at least \$1 billion by class members. As part of the settlement, the settling issuer defendants agreed to assign to class members certain claims they had against the underwriters. Starting in late 2004, purported assignees of certain issuers filed suits in the SDNY against several underwriter defendants, including Morgan Stanley, on the ground that underwriters breached the underwriting agreement and related duties by allocating shares in each company's IPO to customers who allegedly paid the underwriters' excess compensation. On October 11, 2005, the SDNY dismissed the complaint with leave to replead. Plaintiffs filed a second amended complaint, which was dismissed with prejudice on February 24, 2006. Plaintiff filed a notice of appeal on May 31, 2006.

On April 2, 2002, a purported class action complaint, captioned *Breakaway Solutions, Inc. v. Morgan Stanley & Co. Incorporated, et al.*, was filed in the Delaware Court of Chancery against Morgan Stanley and two other



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underwriters. The complaint was brought on behalf of a class of issuers that issued IPO securities from January 1, 1998 to October 31, 2000 pursuant to underwriting agreements with defendants and whose securities increased in value by 15 percent or more within 30 days following the IPO. The complaint alleges that defendants allocated underpriced stock to certain of defendants' favored clients and, directly or indirectly, shared in portions of the profits of such favored clients pursuant to side agreements or understandings, with the alleged effect of depriving issuers of millions of dollars in IPO proceeds. The complaint alleges breach of contract, breach of covenant of good faith, breach of fiduciary duty, indemnification or contribution and unjust enrichment and restitution. The court dismissed plaintiffs' claims except for its breach of fiduciary duty claim.

On September 30, 2005, Breakaway Solutions, Inc. ( Breakaway ) filed another complaint in an individual action against Morgan Stanley and two other underwriters in the Supreme Court of the State of New York. The complaint alleges that defendants underpriced Breakaway's IPO stock, allocated this underpriced stock to favored clients pursuant to a profit sharing arrangement, and that Morgan Stanley improperly sold Breakaway shares before expiration of the lock-up period. The complaint alleges breach of fiduciary duty and breach of the covenant of good faith against all the defendants and fraud and unjust enrichment against Morgan Stanley. This action has been stayed by agreement of the parties.

### **Global Wealth Management Group Employment Matters.**

**Wage and Hour Matters.** Complaints raising allegations of unpaid overtime and unlawful wage deductions against Morgan Stanley have been filed in New Jersey, New York, Connecticut, Texas, Florida, Illinois and California seeking damages on behalf of certain current and former employees. In New Jersey, a purported class action, captioned *Steinberg v. Morgan Stanley & Co., Inc. and Morgan Stanley DW Inc.*, was filed in the Superior Court of New Jersey, Law Division, Bergen County ( New Jersey Superior Court ) on September 1, 2005 and was removed to the U.S. District Court for the District of New Jersey (the New Jersey District Court ) on October 7, 2005. A second purported class action, captioned *Robert Adler et al. v. Morgan Stanley & Co., Inc. and Morgan Stanley DW Inc.*, was filed in New Jersey Superior Court on May 22, 2006. On September 25, 2006, a third purported New Jersey class action, captioned *Jeff Quinn and John Volpe v. Morgan Stanley*, was filed in the New Jersey District Court.

On September 9, 2005, a purported class action, captioned *Gasman v. Morgan Stanley*, was filed in the SDNY. On September 23, 2005, another purported class action, captioned *Roles v. Morgan Stanley et al.*, was filed in the U.S. District Court for the Eastern District of New York.

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 June 23, 2006, a purported class action, captioned *Kyle R. Armitage v. Morgan Stanley & Co., Inc.*, was filed in the U.S. District Court for the Eastern District of Texas. On September 15, 2006, Morgan Stanley filed its answer and affirmative defenses to the *Armitage* complaint. On June 26, 2006, a purported class action, captioned *Jennifer Taub v. Morgan Stanley DW Inc.*, was filed in the U.S. District Court for the Southern District of Florida. On August 24, 2006, a purported class action, captioned *Joseph Stowell, Jr., v. Morgan Stanley DW Inc.*, was filed in the U.S. District Court for the Central District of Illinois. On September 8, 2006, plaintiffs in the *Armitage* and *Stowell* matters moved before the Judicial Panel on Multi-District Litigation (the Judicial Panel ) to coordinate the various pending matters in the U.S. District Court for the Northern District of Illinois (the Northern District of Illinois ).

On October 18, 2006, a purported class action, captioned *Vernon Brown v. Morgan Stanley* was filed in the U.S. District Court for the Southern District of California (the Southern District of California ).

On October 9, 2006, Morgan Stanley reached an agreement to resolve the wage and hour claims filed by the *Steinberg, Adler, Gasman, Roles, Lenihan* and *Brown* plaintiffs. The agreement, which is subject to, among other things, court approval, will resolve all claims brought by



plaintiffs in New Jersey, New York, Connecticut and

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California as well as those of all other potential class members nationwide. On November 29, 2006, for purposes of executing the settlement, a consolidated amended complaint, captioned *Steinberg, et al. v. Morgan Stanley (Steinberg II)*, was filed in the Southern District of California.

On November 21, 2006, the *Taub* matter was dismissed with prejudice.

On November 30, 2006, a hearing was held in St. Louis, Missouri before the Judicial Panel on the *Armitage* and *Stowell* plaintiffs' motion for consolidation in the Northern District of Illinois. On December 27, 2006, the Panel issued an order centralizing the *Gasman, Roles, Steinberg, Lenihan, Armitage* and *Stowell* matters in the Southern District of California. The Judicial Panel also treated the *Quinn, Brown* and *Steinberg II* matters as potential tag along cases and issued a conditional transfer order transferring those cases to the Southern District of California as well.

**Gender Matters.** Morgan Stanley 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 U.S. District Court for the District of Columbia. 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.

On October 12, 2006, a first amended complaint adding an additional named plaintiff, Denise Williams, was filed in the *Jaffe* matter. On October 30, 2006, Morgan Stanley filed a motion to stay the class claims and a motion to dismiss certain of plaintiff Williams' claims. On November 13, 2006, plaintiffs agreed to voluntarily dismiss without prejudice the claims which were the subject of Morgan Stanley's motion to dismiss. On January 19, 2007, the court granted Morgan Stanley's motion to stay the class-wide allegations until March 15, 2007.

## **Late Trading and Market Timing.**

Starting in July 2003, Morgan Stanley received subpoenas and requests for information from various regulatory and governmental agencies, including the SEC, the NYSE and various states, in connection with industry-wide investigations of broker-dealers and mutual fund complexes relating to possible late trading and market timing of mutual funds. Morgan Stanley continues to cooperate with and provide information to regulators in connection with their inquiries.

## **AOL Time Warner Litigation.**

Since 2003, Morgan Stanley has been named as a defendant in a number of state court actions involving AOL Time Warner, including cases in California, Ohio and West Virginia. All of these cases also name as defendants AOL Time Warner, numerous individual defendants, AOL Time Warner's auditors and other investment banking defendants. The complaints allege that AOL Time Warner issued false and misleading financial statements by, among other things, inflating advertising revenues. These complaints name Morgan Stanley in its capacity as financial advisor to Time Warner in the merger of America Online and Time Warner and/or as underwriter of bond offerings completed in 2001 and 2002. The complaints allege violations of Section 11 of the Securities Act and Section 14(a) of the Exchange Act (and Rule 14a-9 thereunder) in connection with the merger registration statement, as well as various state and common laws and violations of Section 11 and 12(a)(2) of the Securities Act in connection with the bond registration statements.

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In the coordinated California proceedings, claims based on California common law fraud and Sections 25400 and 25500 of the California Corporations Code remain against Morgan Stanley. In the Ohio action, state securities law claims remain against Morgan Stanley. Motions to dismiss are pending in the West Virginia action.

On January 30, 2006, numerous new individual actions were filed against Morgan Stanley and other defendants by plaintiffs opting out of the class settlement of a previously filed federal class action. The claims against

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Morgan Stanley in that class action had been dismissed by the SDNY. The new complaints contain similar factual allegations against Morgan Stanley and assert similar claims, but also include a claim for violation of Section 10(b) of the Exchange Act. These actions were transferred to the SDNY and consolidated. Plaintiffs have filed amended complaints in these actions. On June 30, 2006, defendants filed motions to dismiss the claims common to all complaints.

### **Global Wealth Management Group NASD Email Matter.**

On December 19, 2006, the NASD commenced a disciplinary proceeding against MSDWI, alleging that it provided false information regarding the existence of emails and failed to provide such emails to arbitration claimants and regulators in response to discovery obligations and regulatory inquiries, failed to preserve books and records and failed to establish and maintain systems and written procedures reasonably designed to preserve required records and to ensure that it conducted adequate searches in response to regulatory inquiries and discovery requests for email, in violation of section 17(a) of the Exchange Act, Rule 17a-4 thereunder, NASD Conduct Rules 2110, 3010 (a) and (b) and 3110, NASD Procedural Rule 8210 and Interpretative Material 10100 under NASD Code of Arbitration Procedure.

### **Shareholder Derivative Matters.**

Beginning on July 19, 2005, shareholder plaintiffs filed purported derivative actions on behalf of Morgan Stanley against certain present and former directors and its former chief legal officer based on, among other things, agreements to pay the former CEO and co-President of Morgan Stanley and the handling of a lawsuit resulting in an adverse judgment against Morgan Stanley. Four lawsuits filed in the SDNY have been consolidated, under the heading *In re Morgan Stanley Derivative Litigation*, and on January 23, 2006, plaintiffs filed a second amended consolidated complaint that includes claims for, among other things, violations of Sections 10(b) and 14(a) of the Exchange Act and breach of fiduciary duties and seeks, among other things, rescission of the severance and compensation agreements and damages. On March 9, 2006, defendants moved to dismiss.

On July 19, 2005, a derivative lawsuit was filed in a New York state court challenging the agreement to pay the former co-President of Morgan Stanley and seeking an accounting for losses as a result thereof. This matter has been stayed by agreement of the parties.

### **Indonesian Litigation.**

In November 2003, two proceedings were initiated in the Indonesian District Courts by two members of the Asia Pulp & Paper Group (PT Indah Kiat Pulp & Paper Tbk and PT Lontar Papyrus Pulp & Paper Industry, respectively) against Morgan Stanley and 13 other defendants with respect to two bond issues in 1994 and 1995 that were guaranteed by plaintiffs and in which Morgan Stanley acted as underwriter. The claims alleged that the bond issues were invalid and contrary to Indonesian law, and alleged damages in the amount of all principal and interest paid under the bonds as well as other amounts. In November 2006 the Indonesian Supreme Court upheld the decisions at first instance and on appeal in favor of the plaintiff and declared the bond issues to be illegal and void, holding that defendants (including Morgan Stanley) had committed unspecified tortious acts, but awarding no damages.

In April 2004, another proceeding was filed in the Indonesian District Courts by PT Lontar Papyrus against Morgan Stanley and 28 other defendants, alleging that the defendants violated injunctions issued by the Indonesian District Court in the first claim brought by PT Lontar Papyrus and conspired to cause the failure of plaintiff's restructuring negotiations. Plaintiff seeks damages in respect of losses allegedly suffered.

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On September 28, 2005, the Indonesian District Court rejected the plaintiff's claim against Morgan Stanley. On September 13, 2006, Morgan Stanley filed its counter-arguments to the plaintiff's memorandum of appeal that was filed with the Indonesian High Court on April 19, 2006.

In October 2004, an additional proceeding was filed in the Indonesian District Courts by APP International Finance Company BV, a member of the Asia Pulp & Paper Group and the issuer of the 1995 bond issue, against

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Morgan Stanley and 18 other defendants, making allegations similar to those in the November 2003 claim brought by PT Lontar Papyrus. Plaintiff seeks damages in respect of losses allegedly suffered. On December 28, 2006, the Indonesian District Court issued its judgment, declaring the bond issue to be illegal and void, holding that defendants (including Morgan Stanley) had committed unspecified tortious acts, but awarding no damages. Morgan Stanley has appealed this decision to the Indonesian High Court.

In January 2005, an additional proceeding was filed in the Indonesian District Courts by Indah Kiat International Finance Company BV, a member of the Asia Pulp & Paper Group and the issuer of the 1994 bond issue, against Morgan Stanley and other defendants, making allegations similar to those in the November 2003 claim brought by PT Indah Kiat. Plaintiff seeks damages in respect of losses allegedly suffered. In October 2006, the Indonesian High Court upheld on appeal the decision of the Indonesian District Court in favor of the plaintiff, declaring the bond issue to be null and void, holding that defendants (including Morgan Stanley) had committed unspecified tortious acts, but awarding no damages. Morgan Stanley has appealed this decision to the Indonesian Supreme Court in Jakarta.

The following matter was terminated during the quarter ended November 30, 2006:

**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 MS&Co., Morgan Stanley 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. Plaintiffs sought compensatory damages of over \$1 billion and punitive damages of over \$3 billion. On November 8, 2006, the court granted final approval of a settlement agreement between the parties to resolve the matter.

**Item 4. Submission of Matters to a Vote of Security Holders.**

There were no matters submitted to a vote of security holders during the fourth quarter of our fiscal year ended November 30, 2006.

**Table of Contents****Part II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Morgan Stanley's common stock trades on the NYSE under the symbol MS. At January 31, 2007, Morgan Stanley had approximately 101,062 holders of record; however, Morgan Stanley believes the number of beneficial owners of common stock exceeds this number.

The table below sets forth, for each of the last eight fiscal quarters, the low and high sales prices per share of Morgan Stanley's common stock as reported by Bloomberg Financial Markets and the amount of any cash dividends declared per share of Morgan Stanley's common stock.

	<b>Low Sale Price</b>	<b>High Sale Price</b>	<b>Dividends</b>
<b>Fiscal 2006:</b>			
Fourth Quarter	\$65.26	\$80.00	\$0.27
Third Quarter	\$54.52	\$69.50	\$0.27
Second Quarter	\$57.58	\$66.00	\$0.27
First Quarter	\$55.89	\$62.15	\$0.27
<b>Fiscal 2005:</b>			
Fourth Quarter	\$50.61	\$57.98	\$0.27
Third Quarter	\$48.61	\$54.61	\$0.27
Second Quarter	\$47.66	\$60.40	\$0.27
First Quarter	\$51.00	\$60.51	\$0.27

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The table below sets forth the information with respect to purchases made by or on behalf of Morgan Stanley of its common stock during the fourth quarter of our fiscal year ended November 30, 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 (Sept. 1, 2006 Sept. 30, 2006)</b>				
Equity Anti-dilution Program (A)	281,889	\$ 71.25	281,889	(A)
Capital Management Program (B)		N/A		\$ 600
Employee Transactions (D)	2,582,654	\$ 66.49	N/A	N/A
<b>Month #2 (Oct. 1, 2006 Oct. 31, 2006)</b>				
Equity Anti-dilution Program (A)	4,704,445	\$ 75.76	4,704,445	(A)
Capital Management Program (B)		N/A		\$ 600
Employee Transactions (D)	190,788	\$ 76.24	N/A	N/A
<b>Month #3 (Nov. 1, 2006 Nov. 30, 2006)</b>				
Equity Anti-dilution Program (A)	8,061,526	\$ 76.78	8,061,526	(A)
Capital Management Program (B)		N/A		\$ 600
Employee Transactions (D)	44,771	\$ 76.58	N/A	N/A
<b>Total</b>				
Equity Anti-dilution Program (A)	13,047,860	\$ 76.29	13,047,860	(A)
Capital Management Program (B)		N/A		\$ 600
Employee Transactions (D)	2,818,213	\$ 67.31	N/A	N/A

(A) Morgan Stanley's Board of Directors authorized this program to purchase common stock to offset the dilutive impact of grants and exercises of awards under Morgan Stanley's equity-based compensation and benefit plans. At the time the program was publicly announced on January 7, 1999, it had no set expiration or termination date. There is no maximum amount of shares that may be purchased under the program.

(B) Morgan Stanley'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 November 30, 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 Morgan Stanley 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. Morgan Stanley's employee stock compensation plans provide that the value of the shares delivered or attested, or withheld, shall be valued using the fair market value of Morgan Stanley common stock on the date the relevant transaction occurs, using a valuation methodology established by Morgan Stanley.

On December 19, 2006, Morgan Stanley announced that its Board of Directors authorized the repurchase of up to \$6 billion of Morgan Stanley's outstanding stock under a new share repurchase program. The new program replaces the Company's Equity Anti-dilution Program and Capital Management Program with one repurchase program for capital management purposes that will consider, among other things, business segment capital needs, as well as equity-based compensation and benefit plan requirements. Morgan Stanley expects to exercise the authorization over



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the next 12-18 months at prices Morgan Stanley deems appropriate, subject to its surplus capital position, market conditions and regulatory considerations.

Information relating to compensation plans under which Morgan Stanley equity securities are authorized for issuance is set forth in Morgan Stanley's definitive proxy statement for its annual shareholders meeting to be held on April 10, 2007 (to be filed within 120 days after November 30, 2006) (Morgan Stanley's Proxy Statement) under the captions Item 3 Company proposal to approve the 2007 Equity Incentive Plan and Equity Compensation Plan Information and is incorporated by reference herein.

**Table of Contents****Item 6. Selected Financial Data.****MORGAN STANLEY****SELECTED FINANCIAL DATA**

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

	2006	2005	Fiscal Year 2004	2003	2002
<b>Income Statement Data:</b>					
Revenues:					
Investment banking	\$ 4,755	\$ 3,843	\$ 3,341	\$ 2,440	\$ 2,478
Principal transactions:					
Trading	11,738	7,365	5,510	6,262	3,521
Investments	1,669	981	607	110	(25)
Commissions	3,810	3,363	3,264	2,887	3,191
Fees:					
Asset management, distribution and administration	5,288	4,958	4,473	3,814	4,033
Merchant, cardmember and other fees, net	1,167	1,323	1,317	1,377	1,421
Servicing and securitization income	2,338	1,609	1,921	1,922	2,032
Interest and dividends	45,216	28,175	18,584	15,738	15,876
Other	570	464	324	226	399
Total revenues	76,551	52,081	39,341	34,776	32,926
Interest expense	41,937	24,425	14,707	12,693	12,515
Provision for consumer loan losses	756	878	926	1,266	1,337
Net revenues	33,858	26,778	23,708	20,817	19,074
Non-interest expenses:					
Compensation and benefits	14,387	11,313	9,853	8,522	7,910
Other	8,471	8,355	7,037	6,135	6,070
Restructuring and other charges					235
September 11 <sup>th</sup> related insurance recoveries, net		(251)			
Total non-interest expenses	22,858	19,417	16,890	14,657	14,215
Income from continuing operations before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption and cumulative effect of accounting change, net					
	11,000	7,361	6,818	6,160	4,859
Losses from unconsolidated investees	228	311	328	279	77
Provision for income taxes	3,275	1,858	1,856	1,707	1,625
Dividends on preferred securities subject to mandatory redemption			45	154	87
Income from continuing operations before cumulative effect of accounting change, net	7,497	5,192	4,589	4,020	3,070
Discontinued operations:					
Loss from discontinued operations	(42)	(486)	(172)	(393)	(138)
Income tax benefit	17	184	69	160	56

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Loss on discontinued operations	(25)	(302)	(103)	(233)	(82)
Cumulative effect of accounting change, net		49			
Net income	\$ 7,472	\$ 4,939	\$ 4,486	\$ 3,787	\$ 2,988
Preferred stock dividend requirements	\$ 19	\$	\$	\$	\$
Earnings applicable to common shares(1)	\$ 7,453	\$ 4,939	\$ 4,486	\$ 3,787	\$ 2,988

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	2006	2005	Fiscal Year 2004	2003	2002
<b>Per Share Data:</b>					
Earnings per basic common share:					
Income from continuing operations	\$ 7.40	\$ 4.94	\$ 4.25	\$ 3.74	\$ 2.84
Loss on discontinued operations	(0.02)	(0.29)	(0.10)	(0.22)	(0.08)
Cumulative effect of accounting change, net		0.05			
Earnings per basic common share	\$ 7.38	\$ 4.70	\$ 4.15	\$ 3.52	\$ 2.76
<b>Earnings per diluted common share:</b>					
Income from continuing operations	\$ 7.09	\$ 4.81	\$ 4.15	\$ 3.66	\$ 2.76
Loss on discontinued operations	(0.02)	(0.29)	(0.09)	(0.21)	(0.07)
Cumulative effect of accounting change, net		0.05			
Earnings per diluted common share	\$ 7.07	\$ 4.57	\$ 4.06	\$ 3.45	\$ 2.69
Book value per common share	\$ 32.67	\$ 27.59	\$ 25.95	\$ 22.93	\$ 20.24
Dividends per common share	\$ 1.08	\$ 1.08	\$ 1.00	\$ 0.92	\$ 0.92
<b>Balance Sheet and Other</b>					
<b>Operating Data:</b>					
Total assets	\$ 1,120,645	\$ 898,523	\$ 747,334	\$ 602,843	\$ 529,499
Consumer loans, net	24,173	22,916	20,226	19,382	23,014
Total capital(2)	162,134	125,891	110,793	82,769	65,936
Long-term borrowings(2)	126,770	96,709	82,587	57,902	44,051
Shareholders' equity	35,364	29,182	28,206	24,867	21,885
Return on average common shareholders equity	23.5%	17.3%	16.8%	16.5%	14.1%
Average common and equivalent shares(1)	1,010,254,255	1,049,896,047	1,080,121,708	1,076,754,740	1,083,270,783

(1) Amounts shown are used to calculate earnings per basic common share.

(2) These amounts exclude the current portion of long-term borrowings and include Capital Units and junior subordinated debt issued to capital trusts.

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**Item 7. 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 a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. A summary of the activities of each of the segments follows:

*Institutional Securities* includes capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; sales, trading, financing and market-making activities in equity 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 services; retirement services; and trust and fiduciary services.

*Asset Management* provides global asset management products and services in equity, fixed income, alternative investments and private equity to institutional and retail clients through proprietary and third party retail distribution channels, intermediaries and the Company's institutional distribution channel. Asset Management also engages in investment activities.

*Discover* offers Discover®-branded credit cards and related consumer products and services and operates the Discover Network, 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. Discover also offers consumer finance products and services in the U.K., including Morgan Stanley-branded, Goldfish-branded and various other credit cards issued on the MasterCard and Visa networks.

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover (the Discover Spin-off) (see Discover Spin-off herein).

The Company's results of operations for the 12 months ended November 30, 2006 (fiscal 2006), November 30, 2005 (fiscal 2005) and November 30, 2004 (fiscal 2004) are discussed below. The results of the aircraft leasing business are reported as discontinued operations for all periods presented through its sale on March 24, 2006 (see Discontinued Operations herein).

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

	2006	Fiscal Year 2005	2004
<b>Net revenues (dollars in millions):</b>			
Institutional Securities	\$ 21,562	\$ 15,673	\$ 13,113
Global Wealth Management Group	5,505	5,019	4,615
Asset Management	2,770	2,907	2,738
Discover	4,290	3,452	3,533
Intersegment Eliminations	(269)	(273)	(291)
Consolidated net revenues	\$ 33,858	\$ 26,778	\$ 23,708
<b>Income before taxes (dollars in millions)(1):</b>			
Institutional Securities	\$ 8,160	\$ 4,754	\$ 4,281
Global Wealth Management Group	509	585	371
Asset Management	711	1,007	827
Discover	1,587	921	1,221
Intersegment Eliminations	33	94	118
Consolidated income before taxes	\$ 11,000	\$ 7,361	\$ 6,818
<b>Consolidated net income (dollars in millions)</b>	<b>\$ 7,472</b>	<b>\$ 4,939</b>	<b>\$ 4,486</b>
<b>Earnings applicable to common shareholders (dollars in millions)(2)</b>	<b>\$ 7,453</b>	<b>\$ 4,939</b>	<b>\$ 4,486</b>
<b>Earnings per basic common share:</b>			
Income from continuing operations	\$ 7.40	\$ 4.94	\$ 4.25
Loss on discontinued operations	(0.02)	(0.29)	(0.10)
Cumulative effect of accounting change, net		0.05	
Earnings per basic common share	\$ 7.38	\$ 4.70	\$ 4.15
<b>Earnings per diluted common share:</b>			
Income from continuing operations	\$ 7.09	\$ 4.81	\$ 4.15
Loss on discontinued operations	(0.02)	(0.29)	(0.09)
Cumulative effect of accounting change, net		0.05	
Earnings per diluted common share	\$ 7.07	\$ 4.57	\$ 4.06
<b>Statistical Data.</b>			
<b>Book value per common share(3)</b>	<b>\$ 32.67</b>	<b>\$ 27.59</b>	<b>\$ 25.95</b>
<b>Average common equity (dollars in billions)(4):</b>			

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Institutional Securities	\$ 18.2	\$ 14.6	\$ 13.3
Global Wealth Management Group	3.2	3.7	3.5
Asset Management	2.2	1.7	1.7
Total from securities businesses	23.6	20.0	18.5
Discover	4.9	4.4	3.9
Total from operating segments	28.5	24.4	22.4
Discontinued operations		1.2	1.5
Unallocated capital	3.2	2.9	2.8
Consolidated	\$ 31.7	\$ 28.5	\$ 26.7

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

	2006	Fiscal Year 2005	2004
<b>Return on average common equity(4):</b>			
Consolidated	23%	17%	17%
Institutional Securities	31%	24%	22%
Global Wealth Management Group	11%	11%	7%
Asset Management	19%	36%	30%
Discover	22%	13%	20%
<b>Effective income tax rate</b>	30.4%	26.5%	28.8%
<b>Worldwide employees</b>	55,310	53,218	53,284
<b>Consolidated assets under management or supervision by asset class (dollars in billions):</b>			
Equity	\$ 325	\$ 285	\$ 246
Fixed income	113	108	118
Money market	89	83	87
Alternative investments	21	19	19
Real estate	64	41	31
Subtotal	612	536	501
Unit trusts	14	12	11
Other(5)	63	51	44
Total assets under management or supervision(6)	689	599	556
Share of minority interest assets(7)	4		
Total	\$ 693	\$ 599	\$ 556
<b>Institutional Securities:</b>			
Mergers and acquisitions completed transactions (dollars in billions)(8):			
Global market volume	\$ 723.7	\$ 518.3	\$ 351.6
Market share	26.8%	24.6%	23.7%
Rank	2	3	2
Mergers and acquisitions announced transactions (dollars in billions)(8):			
Global market volume	\$ 977.2	\$ 725.0	\$ 320.7
Market share	27.4%	28.6%	19.2%
Rank	3	2	5
Global equity and equity-related issues (dollars in billions)(8):			
Global market volume	\$ 57.3	\$ 45.9	\$ 54.3
Market share	8.2%	8.7%	10.6%
Rank	3	3	1
Global debt issues (dollars in billions)(8):			
Global market volume	\$ 397.3	\$ 347.2	\$ 362.2
Market share	5.7%	5.7%	6.9%
Rank	5	5	3
Global initial public offerings (dollars in billions)(8):			
Global market volume	\$ 22.7	\$ 14.7	\$ 13.9
Market share	8.8%	8.9%	10.0%
Rank	2	2	1
Pre-tax profit margin(9)	38%	30%	32%



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

	2006	Fiscal Year 2005	2004
<b>Global Wealth Management Group:</b>			
Global representatives	8,030	9,526	10,962
Annualized net revenue per global representative (dollars in thousands)(10)	\$ 643	\$ 495	\$ 424
Client assets by segment (dollars in billions)(10):			
\$10 million or more	\$ 202	\$ 157	\$ 140
\$1 million \$10 million	248	218	202
Subtotal \$1 million or more	450	375	342
\$100,000 \$1 million	179	181	193
Less than \$100,000	26	32	40
Client assets excluding corporate and other accounts	655	588	575
Corporate and other accounts	31	29	27
Total client assets	\$ 686	\$ 617	\$ 602
Fee-based assets as a percentage of total client assets	30%	28%	26%
Client assets per global representative (dollars in millions)(11)	\$ 85	\$ 65	\$ 55
Bank deposit program (dollars in millions)(12)	\$ 13,301	\$ 1,689	\$ 435
Pre-tax profit margin(9)	9%	12%	8%
<b>Asset Management:</b>			
Assets under management or supervision (dollars in billions)(13)	\$ 478	\$ 431	\$ 424
Percent of fund assets in top half of Lipper rankings(14)	40%	61%	63%
Pre-tax profit margin(9)	26%	35%	30%
<b>Discover (dollars in millions, unless otherwise noted)(15):</b>			
Period-end credit card loans Owned	\$ 23,588	\$ 22,496	\$ 19,724
Period-end credit card loans Managed	\$ 50,291	\$ 46,936	\$ 48,261
Average credit card loans Owned	\$ 21,647	\$ 19,932	\$ 17,608
Average credit card loans Managed	\$ 48,207	\$ 47,330	\$ 47,387
Net principal charge-off rate Owned	3.79%	4.84%	5.53%
Net principal charge-off rate Managed	4.08%	5.23%	6.00%
Return on average receivables Owned	4.98%	2.92%	4.43%
Return on average receivables Managed	2.24%	1.23%	1.65%
Transaction volume (dollars in billions):			
Net sales	\$ 96.6	\$ 86.0	\$ 79.5
Other transaction volume	18.1	18.1	20.1
Total	\$ 114.7	\$ 104.1	\$ 99.6
Payment services transaction volume (in millions):			
Discover network	1,399	1,301	1,226
PULSE network	1,857	1,556	
Total network transaction volume	3,256	2,857	1,226
Pre-tax profit margin(9)	37%	27%	35%

(1) Amounts represent income from continuing operations before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption and cumulative effect of accounting change, net.

(2) Earnings applicable to common shareholders are used to calculate earnings per share (EPS) information. Fiscal 2006 includes a preferred stock dividend of \$19 million.

(3) Book value per common share equals common shareholders' equity of \$34,264 million at November 30, 2006, \$29,182 million at November 30, 2005 and \$28,206 million at November 30, 2004, divided by common shares outstanding of 1,049 million at November 30, 2006, 1,058 million at November 30, 2005 and 1,087 million at November 30, 2004.



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- (4) The computation of average common equity for each segment is based upon an economic capital model that the Company uses 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 intangible assets, 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 segment.
- (6) Revenues and expenses associated with these assets are included in the Company's Asset Management, Global Wealth Management Group and Institutional Securities business segments.
- (7) Amount represents Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (8) Source: Thomson Financial, data as of January 2, 2007. The data for fiscal 2006, fiscal 2005 and fiscal 2004 are for the periods from January 1 to December 31, 2006, January 1 to December 31, 2005 and January 1 to December 31, 2004, respectively, as Thomson Financial presents these data on a calendar-year basis.
- (9) 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.
- (10) Annualized net revenue per global representative amounts equal Global Wealth Management Group's net revenues divided by the quarterly average global representative headcount for the periods presented. Fiscal 2005 and fiscal 2004 amounts were restated to conform to the current year's presentation. Global Wealth Management Group's fiscal 2005 and fiscal 2004 client assets by segment were also reclassified to conform to the current year's presentation.
- (11) Client assets per global representative equals total client assets divided by period-end global representative headcount.
- (12) 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.
- (13) Amount includes Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (14) Source: Lipper, one-year performance excluding money market funds as of November 30, 2006, November 30, 2005 and November 30, 2004, respectively.
- (15) 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.

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**Fiscal 2006 Performance.**

**Company Results.** The Company recorded net income of \$7,472 million in fiscal 2006, a 51% increase from \$4,939 million in the prior year. Net revenues (total revenues less interest expense and the provision for loan losses) rose 26% to a record \$33,858 million in fiscal 2006, and non-interest expenses increased 18% to \$22,858 million. Diluted earnings per share were \$7.07 compared with \$4.57 a year ago. Compensation and benefits expense increased 27%, primarily reflecting higher net revenues. Non-compensation expenses increased 5% as costs associated with higher levels of business activity were partially offset by lower charges for legal and regulatory matters. Diluted earnings per share from continuing operations were \$7.09 compared with \$4.81 last year. The return on average common equity in fiscal 2006 was 23.5% compared with 17.3% in the prior year. The return on average common equity from continuing operations for fiscal 2006 was 23.6% compared with 19.0% last year.

Results for fiscal 2006 included non-cash incremental compensation expenses of approximately \$270 million for stock-based awards granted to retirement-eligible employees (see *Other Items* *Stock-Based Compensation* herein). Results for fiscal 2005 included a charge of \$509 million (\$316 million after-tax) for discontinued operations related to the sale of the aircraft leasing business (see *Other Items* *Discontinued Operations* herein). In addition, pre-tax results for fiscal 2005 included a \$360 million charge related to the *Coleman Litigation*, legal accruals of approximately \$120 million related to the Parmalat matter, a \$109 million charge for the correction in the method of accounting for certain real estate leases, charges for senior management severance and new hires of approximately \$311 million, and a gain of \$251 million related to an insurance settlement (see *Other Items* herein).

The Company's effective income tax rate was 30.4% in fiscal 2006 compared with 26.5% in fiscal 2005. Fiscal 2006's income tax provision included an income tax benefit of \$280 million resulting from the resolution of a federal tax audit, while fiscal 2005's income tax provision included an income tax benefit of \$309 million related to the provisions of the American Jobs Creation Act (see *Other Items* herein). Excluding the benefits from the federal tax audit and the American Jobs Creation Act, the Company's effective income tax rates in fiscal 2006 and fiscal 2005 would have been 33.0% and 30.8%, respectively. The increase primarily reflected lower estimated domestic tax credits and higher earnings, which reduced the effect of permanent differences, partially offset by the effects of lower tax rates applicable to non-U.S. earnings.

At fiscal year-end, the Company had 55,310 employees worldwide compared with 53,218 at the prior year-end.

**Institutional Securities.** Institutional Securities recorded income from continuing operations before losses from unconsolidated investees, income taxes and net cumulative effect of accounting change of \$8,160 million, a 72% increase from a year ago. Net revenues rose 38% to \$21,562 million driven by record results in fixed income and equity sales and trading and fixed income underwriting, along with strong results in advisory revenues. Non-interest expenses increased 23% to \$13,402 million, primarily due to higher compensation and benefits expense resulting from higher net revenues. Non-compensation expenses were relatively unchanged as higher costs associated with higher levels of business activity were offset by lower charges for legal and regulatory matters.

Investment banking revenues rose 24% from last year to \$4,318 million. Underwriting revenues rose 24% from last year to \$2,475 million. Advisory fees from merger, acquisition and restructuring transactions were \$1,843 million, an increase of 25% from fiscal 2005.

Fixed income sales and trading revenues were a record \$9,577 million, up 41% from a year ago. The increase was driven by record results from commodities, credit products, and interest rate and currency products. Commodities revenues reflected strong results from electricity, natural gas products and oil liquids. Credit product revenues benefited from significantly improved corporate credit trading and strength in residential and commercial securitized products. Commodities and interest rate and currency products benefited from revenues recognized on structured

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transactions as a result of increased observability of market value (see Other Items Accounting Developments Fair Value Measurements herein). Equity sales and trading revenues were a record \$6,320 million, up 32% from a year ago. The increase was broad based and included higher revenues from derivatives and equity cash products, financing products, prime brokerage and principal trading strategies.

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Principal transaction net investment revenues increased 125% to \$1,477 million in fiscal 2006. Fiscal 2006's results 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, IntercontinentalExchange, Grifols S.A., the NYSE Group, Inc. (the NYSE) and Wacker Chemie AG.

**Global Wealth Management Group.** Global Wealth Management Group recorded income before taxes and net cumulative effect of accounting change of \$509 million, down 13% from the prior year. Fiscal 2005 included a benefit of \$198 million resulting from the insurance settlement related to the events of September 11, 2001 (see Other Items Insurance Settlement herein), partially offset by a \$29 million charge for the correction in the method of accounting for certain real estate leases (see Other Items Lease Adjustment herein). Net revenues were \$5,505 million, a 10% increase over a year ago, primarily reflecting higher net interest revenue from the bank deposit program and an increase in revenues from fee-based products. Total non-interest expenses were \$4,996 million, a 13% increase from a year ago. Excluding the insurance settlement and the lease adjustment, total non-interest expenses increased 9%, primarily reflecting higher compensation and benefits expense resulting from higher net revenues, partially offset by lower non-compensation expenses due to lower charges for legal and regulatory costs. Total client assets increased to \$686 billion, up 11% from the prior fiscal year-end. In addition, client assets in fee-based accounts increased 19% from a year ago to a record \$206 billion and increased as a percentage of total client assets to 30% from last year's 28%. At fiscal year-end, the number of global representatives was 8,030, a decline of 1,496 from a year ago, resulting largely from planned sales force reductions completed in the second quarter of fiscal 2006 and attrition.

**Asset Management.** Asset Management recorded income before taxes and net cumulative effect of accounting change of \$711 million, a 29% decrease from last year. Net revenues of \$2,770 million decreased 5% from the prior year, largely due to lower investment revenues, primarily in the private equity business. Principal transaction net investment gains for the year were \$139 million compared with \$326 million a year ago. Non-interest expenses increased 8% from the prior year to \$2,059 million, primarily reflecting higher compensation and benefits expense associated with critical business initiatives to retain and attract new talent in the business and support areas. Assets under management or supervision within Asset Management of \$478 billion were up \$47 billion, or 11%, from last year, primarily due to market appreciation, partially offset by net outflows of customer assets. In fiscal 2007, the Company expects that Asset Management's profit margins will be affected by its continued investments in its core business, alternative products and private equity.

**Discover.** Discover recorded record income before losses from unconsolidated investees, income taxes and net cumulative effect of accounting change of \$1,587 million, an increase of 72% from last year. Net revenues of \$4,290 million were 24% higher than a year ago, benefiting from improvements in credit quality and a continued favorable impact on charge-offs following the enactment of federal bankruptcy legislation that became effective in October 2005. Servicing and securitization income of \$2,338 million increased 45% from a year ago due primarily to a lower Provision for consumer loan losses and higher Merchant, cardmember and other fees, net. The increase also reflected higher Other revenues, which was attributable to an increase in the fair value of the Company's retained interests in securitized receivables. Non-interest expenses of \$2,703 million increased 7% from the prior year, primarily due to costs associated with the Goldfish acquisition (see Other Items Business and Other Acquisitions and Dispositions herein), higher compensation and benefits expense and higher legal costs. In fiscal 2006, Discover's results benefited from the continued favorable credit environment. In fiscal 2007, the Company expects Discover's margins to return to more normal levels.

The managed credit card net principal charge-off rate decreased 115 basis points from a year ago to 4.08%. The managed over 30-day delinquency rate decreased 47 basis points to 3.51% from a year ago, and the managed over 90-day delinquency rate was 10 basis points lower than a year ago at 1.65%. Managed credit card loans were \$50,291 million at year-end, a 7% increase from a year ago.

**Global Market and Economic Conditions in Fiscal 2006.**

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Global market and economic conditions were generally favorable throughout most of fiscal 2006, which contributed to the increased revenues and net income achieved by the Company during the fiscal year. Although

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there were concerns about energy prices, inflation and geopolitical risks, activity in the global capital markets was robust, and the volume of merger and acquisition and underwriting transactions increased from the prior year.

The U.S. economy continued to demonstrate strength during fiscal 2006. The rate of economic growth was generally strong, although it moderated during the second half of the fiscal year as consumer spending was affected by higher energy prices and a slowdown in the residential real estate market. The U.S. unemployment rate declined to 4.5% from 5.0% at the end of the prior fiscal year. Conditions in the U.S. equity markets were also generally favorable during fiscal 2006. Major equity market indices increased despite experiencing a correction during the summer as the favorable economic environment and strong corporate earnings outweighed concerns about inflation, energy prices and rising interest rates. The Federal Reserve Board (the Fed) raised both the overnight lending rate and the discount rate by an aggregate of 1.25% in fiscal 2006. The Fed held interest rates steady after the end of June, however, as there were indications that inflationary pressures had subsided.

In Europe, economic growth continued at a moderate pace during fiscal 2006, primarily driven by domestic demand and exports. Major equity market indices in Europe increased during the year, reflecting strong corporate profits, merger and acquisition activity, and favorable economic conditions. The European Central Bank (the ECB) raised the benchmark interest rate by an aggregate of 1.25% during fiscal 2006. In December 2006, the ECB raised the benchmark interest rate by an additional 0.25%. Economic growth also continued in the U.K., supported by domestic demand and business investment. The Bank of England (the BOE) raised the benchmark interest rate by an aggregate of 0.50% during fiscal 2006. In January 2007, the BOE raised the benchmark interest rate by an additional 0.25%.

In Japan, economic growth continued to be driven by domestic demand and exports. The level of unemployment also remained relatively low, and Japanese equity market indices increased during the fiscal year. During fiscal 2006, the Bank of Japan raised the benchmark interest rate from 0.0% to 0.25%. Economies elsewhere in Asia also expanded, particularly in China, which benefited from strength in exports, domestic demand and continued globalization. Equity market indices in China increased sharply during the year. In fiscal 2006, the People's Bank of China raised the benchmark interest rate by an aggregate of 0.54%.

**Business Segments.**

The remainder of Results of Operations is presented on a business segment basis before discontinued operations. Substantially all of the Company's operating revenues and operating expenses can be directly attributed to its business segments. Certain revenues and expenses have been allocated to each business segment, generally in proportion to its respective 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 business segment results to the Company's consolidated results. Income before taxes in Intersegment Eliminations primarily represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Asset Management to Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to Global Wealth Management Group's global representatives. Income before taxes recorded in Intersegment Eliminations was \$33 million, \$94 million and \$118 million in fiscal 2006, fiscal 2005 and fiscal 2004, respectively. In addition, the results in Institutional Securities for fiscal 2006 included a \$30 million advisory fee related to the Company's sale of the aircraft leasing business that was eliminated in consolidation.



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

	Fiscal 2006	Fiscal 2005 (dollars in millions)	Fiscal 2004
Revenues:			
Investment banking	\$ 4,318	\$ 3,477	\$ 3,008
Principal transactions:			
Trading	11,272	6,906	4,998
Investments	1,477	656	364
Commissions	2,606	2,160	1,998
Asset management, distribution and administration fees	259	152	144
Interest and dividends	41,979	25,455	16,395
Other	404	301	190
Total revenues	62,315	39,107	27,097
Interest expense	40,753	23,434	13,984
Net revenues	21,562	15,673	13,113
Total non-interest expenses	13,402	10,919	8,832
Income from continuing operations before losses from unconsolidated investees, income taxes, dividends on preferred securities subject to mandatory redemption and cumulative effect of accounting change, net	8,160	4,754	4,281
Losses from unconsolidated investees	225	311	328
Provision for income taxes	2,308	909	932
Dividends on preferred securities subject to mandatory redemption			45
Income from continuing operations before cumulative effect of accounting change, net	\$ 5,627	\$ 3,534	\$ 2,976

**Investment Banking.** Investment banking revenues are derived from the underwriting of securities offerings and fees from advisory services. Investment banking revenues were as follows:

	Fiscal 2006	Fiscal 2005 (dollars in millions)	Fiscal 2004
Advisory fees from merger, acquisition and restructuring transactions	\$ 1,843	\$ 1,478	\$ 1,156
Equity underwriting revenues	1,059	905	993
Fixed income underwriting revenues	1,416	1,094	859
Total investment banking revenues	\$ 4,318	\$ 3,477	\$ 3,008

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Investment banking revenues increased 24% in fiscal 2006. The increase was due to higher revenues from merger, acquisition and restructuring activities and fixed income and equity underwriting transactions. In fiscal 2005, investment banking revenues increased 16%, primarily reflecting higher revenues from merger, acquisition and restructuring activities and fixed income underwriting transactions, partially offset by lower revenues from equity underwritings.

In fiscal 2006, advisory fees from merger, acquisition and restructuring transactions increased 25% to \$1,843 million. Advisory fees in fiscal 2006 reflected certain internal revenues, including a \$30 million fee related to the Company's sale of the aircraft leasing business that was eliminated in consolidation. In fiscal 2005, advisory fees from merger, acquisition and restructuring transactions increased 28% to \$1,478 million. The results in both fiscal years reflected a strong volume of transaction activity as conditions in the worldwide merger and acquisition markets were generally favorable throughout both fiscal 2006 and fiscal 2005.

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Equity underwriting revenues increased 17% to \$1,059 million in fiscal 2006 and reflected higher global industry-wide equity and equity-related activity, most notably relating to a strong volume of initial public offerings. Equity underwriting revenues decreased 9% to \$905 million in fiscal 2005, reflective of lower global industry-wide equity and equity-related activity.

Fixed income underwriting revenues rose 29% to a record \$1,416 million in fiscal 2006 and increased 27% to \$1,094 million in fiscal 2005. The increase in fiscal 2006 was primarily due to an increase in underwriting revenues from non-investment grade and investment grade products as the level of issuer refinancings rose due to record levels of maturing debt. The increase in fiscal 2005 was primarily due to higher revenues from global high-yield and securitized fixed income transactions. Acquisition-related financing resulting from a strong market for merger and acquisition activity contributed to the increases in both fiscal 2006 and fiscal 2005. Both fiscal years also reflected generally favorable conditions in the global fixed income markets, and, although the Fed increased the overnight interest rate in both fiscal years, longer-term interest rates remained at relatively low levels. The attractive debt financing environment contributed to higher revenues as issuers continued to take advantage of relatively low financing costs.

At the end of fiscal 2006, the backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions was higher as compared with the end of fiscal 2005. The backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions is subject to the risk that transactions may not be completed due to unforeseen economic and market conditions, adverse developments regarding one of the parties to the transaction, a failure to obtain required regulatory approval or a decision on the part of the parties involved not to pursue a transaction.

***Sales and Trading 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.

The components of the Company's sales and trading revenues are described below:

***Principal Transactions Trading.*** Principal transaction trading revenues include revenues from customers' purchases and sales of financial instruments in which the Company acts as principal and gains and losses on the Company's positions. The Company also engages in proprietary trading activities for its own account.

***Commissions.*** Commission revenues primarily arise from agency transactions in listed and over-the-counter (OTC) equity securities and options.

***Net Interest.*** Interest and dividend revenues and interest expense are a function of the level and mix of total assets and liabilities, including financial instruments owned and financial instruments sold, not yet purchased, reverse repurchase and repurchase agreements, trading strategies, customer activity in the Company's prime brokerage business, and the prevailing level, term structure and volatility of interest rates. Reverse repurchase and repurchase agreements and securities borrowed and securities loaned transactions may be entered into with different customers using the same underlying securities, thereby generating a spread between the interest revenue on the reverse repurchase agreements or securities borrowed transactions and the interest expense on the repurchase agreements or securities loaned transactions.

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Total sales and trading revenues increased 36% in fiscal 2006 and 18% in fiscal 2005. The increase in both periods reflected higher fixed income and equity sales and trading revenues.

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Sales and trading revenues included the following:

	Fiscal 2006(1)	Fiscal 2005(1)	Fiscal 2004(1)
	(dollars in millions)		
Equity	\$ 6,320	\$ 4,804	\$ 4,067
Fixed income(2)	9,577	6,782	5,567

(1) Amounts exclude sales and trading revenues of \$(793) million, \$(499) million and \$(227) million in fiscal 2006, fiscal 2005 and fiscal 2004, respectively, which relate to unallocated net revenues, net revenues associated with corporate lending activities and certain other adjustments.

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

Equity sales and trading revenues increased 32% to a record \$6,320 million in fiscal 2006. The increase was broad based and included higher revenues from derivatives and equity cash products, financing products, prime brokerage and principal trading strategies. Derivative revenues increased due to strong customer flows, although volatility in the global equity markets continued to be generally low. Revenues from equity cash products reflected higher market volumes, particularly in Europe and Asia. Financing products revenues also benefited from increased client activity. Prime brokerage generated record revenues for the third consecutive fiscal year, reflecting continued growth in global client asset balances. Global equity markets generally trended higher and created favorable opportunities for principal trading strategies. Although commission revenues increased, revenues continued to be affected by intense competition, particularly in the U.S., and a continued shift toward electronic trading.

Equity sales and trading revenues increased 18% in fiscal 2005. The increase was broad based and included increased customer flows in derivatives, higher revenues in prime brokerage, improved performance in principal trading strategies and higher revenues from equity cash products. Derivative revenues increased due to strong customer flows despite continued low levels of volatility in the equity markets. Revenues in prime brokerage were driven by robust growth in client balances. Global equity markets generally trended higher and created favorable trading opportunities for principal trading strategies. Revenue from equity cash products rose on higher market volumes, particularly in the European and Asian markets.

Fixed income sales and trading revenues increased 41% to a record \$9,577 million in fiscal 2006. The increase was driven by record results from commodities, credit products, and interest rate and currency products. Commodities revenues increased 112% due to strong results from electricity, natural gas products and oil liquids. Credit product revenues increased 46%, primarily due to significantly improved corporate credit trading and strength in residential and commercial securitized products. Interest rate and currency products increased 4%. Both commodity and interest rate and currency products benefited from revenues recognized on structured transactions as a result of increased observability of market value in accordance with EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* (EITF Issue No. 02-3). With the adoption of SFAS No. 157, *Fair Value Measurements* (SFAS No. 157) on December 1, 2006, the Company will no longer apply the revenue recognition criteria of EITF Issue No. 02-3 (see *Other Items Accounting Developments Fair Value Measurements* herein).

Fixed income sales and trading revenues increased 22% in fiscal 2005, primarily due to higher revenues from interest rate and currency and credit products, partially offset by lower revenues from commodities products. Interest rate and currency product revenues increased 41% primarily due to higher revenues from interest rate cash and derivative products and higher revenues from emerging market fixed income securities, partially offset by lower revenues from foreign exchange products. Interest rate and currency product revenues benefited from strong new client transaction activity and favorable positioning results. The 19% increase in credit product revenues was primarily due to increased customer flows in securitized products and favorable trading conditions. Commodities revenues decreased 8% from the prior year as lower revenues in oil liquids were partially offset by record results in electricity and natural gas products.



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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 fiscal 2006, revenues from corporate lending activities decreased by approximately \$50 million from the prior year. In fiscal 2005, revenues from corporate lending activities decreased by approximately \$240 million. In both fiscal 2006 and fiscal 2005, revenues from corporate lending activities reflected the impact of mark-to-market valuations on a higher level of new loans made in both fiscal years.

**Principal Transactions-Investments.** The Company's investments generally are held for appreciation and to facilitate other business activities. It is not possible to determine when the Company will realize the value of such investments since, among other factors, such investments generally are subject to significant sales restrictions. Moreover, estimates of the fair value of the investments involve significant judgment and may fluctuate significantly over time in light of business, market, economic and financial conditions generally or in relation to specific transactions.

Principal transaction net investment revenues aggregating \$1,477 million were recognized in fiscal 2006 as compared with \$656 million in fiscal 2005 and \$364 million in fiscal 2004. The increase in fiscal 2006 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, IntercontinentalExchange, Grifols S.A., the NYSE and Wacker Chemie AG. Fiscal 2005's results included gains from investments in IntercontinentalExchange, International Securities Exchange and Digital Globe Inc.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees include revenues from asset management services, primarily fees associated with the Company's real estate fund investment activities.

Asset management, distribution and administration fees increased 70% in fiscal 2006 and 6% in fiscal 2005. The increase in fiscal 2006 was primarily related to higher fees associated with real estate fund investments.

**Other.** Other revenues consist primarily of revenues from providing benchmark indices and risk management analytics associated with Morgan Stanley Capital International Inc., which includes the results of Barra, Inc. ( Barra ). Other revenues also include revenues related to the operation of pipelines, terminals and barges and the distribution of refined petroleum products associated with TransMontaigne Inc. ( TransMontaigne ) and the marine transportation and logistics services associated with the Heidmar Group (see Other Items Business and Other Acquisitions and Dispositions herein).

Other revenues increased 34% in fiscal 2006 and 58% in fiscal 2005. The increase in both fiscal 2006 and fiscal 2005 was primarily attributable to higher sales of benchmark indices and risk management analytic products. The increase in fiscal 2006 was also partly attributable to revenues associated with TransMontaigne, which was acquired on September 1, 2006.

**Non-Interest Expenses.** Non-interest expenses increased 23% in fiscal 2006. Compensation and benefits expense increased 36%, primarily reflecting higher incentive-based compensation costs resulting from higher net revenues. Fiscal 2006 also included Institutional Securities share (\$190 million) of incremental compensation expense related to equity awards to retirement-eligible employees (see Other Items Stock-Based Compensation herein), while fiscal 2005 included Institutional Securities share (\$193 million) of the costs associated with senior management changes (see Other Items Senior Management Compensation Charges herein). Excluding compensation and benefits expense, non-interest expenses remained relatively unchanged. Occupancy and equipment expense decreased 6%, 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 Other Items Lease Adjustment herein). Brokerage, clearing and exchange fees increased 32%, primarily reflecting increased equity and fixed income trading

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activity. Professional services expense increased 18%, primarily due to higher legal and consulting costs, reflecting increased levels of business activity. Other expenses decreased 49%



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due to lower charges for legal and regulatory matters. Fiscal 2006 reflected a net reduction in legal accruals of approximately \$40 million related to the *IPO Allocation Matters*, the LVMH litigation and the settlement of the *General American Litigation*. Other expenses in fiscal 2005 included legal accruals of \$360 million related to the *Coleman Litigation* and approximately \$170 million related to the Parmalat settlement and the *IPO Allocation Matters*.

Fiscal 2005's total non-interest expenses increased 24%. Compensation and benefits expense increased 21%, reflecting higher incentive-based compensation costs due to higher net revenues and Institutional Securities' share (\$193 million) of the costs associated with senior management changes. Excluding compensation and benefits expense, non-interest expenses increased 29%. Occupancy and equipment expense increased 41%, reflecting higher rental costs, primarily in North America. The increase also included a \$71 million charge for the correction in the method of accounting for certain real estate leases. Brokerage, clearing and exchange fees increased 14%, primarily reflecting increased trading activity. Information processing and communications expense increased 11%, primarily due to higher telecommunications, market data and data processing costs. Professional services expense increased 31%, primarily due to higher consulting and legal costs, including costs of \$55 million related to the matters below. Other expenses increased 71%, reflecting legal accruals of \$360 million related to the *Coleman Litigation*, approximately \$170 million related to the Parmalat settlement and the *IPO Allocation Matters*, while fiscal 2004 included legal accruals of \$110 million related to the Parmalat settlement and the *IPO Allocation Matters*.

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## GLOBAL WEALTH MANAGEMENT GROUP

## INCOME STATEMENT INFORMATION

	Fiscal	Fiscal	Fiscal
	2006	2005	2004
	(dollars in millions)		
Revenues:			
Investment banking	\$ 428	\$ 320	\$ 290
Principal transactions:			
Trading	474	464	518
Investments	53	(1)	(5)
Commissions	1,208	1,228	1,327
Asset management, distribution and administration fees	2,693	2,517	2,099
Interest and dividends	1,018	662	409
Other	155	167	133
Total revenues	6,029	5,357	4,771
Interest expense	524	338	156
Net revenues	5,505	5,019	4,615
Total non-interest expenses	4,996	4,434	4,244
Income before taxes and cumulative effect of accounting change, net	509	585	371
Provision for income taxes	164	197	120
Income before cumulative effect of accounting change, net	\$ 345	\$ 388	\$ 251

The revenues and expenses discussed below include the results of Quilter Holdings Ltd. ( Quilter ), the Global Wealth Management Group's standalone U.K. mass affluent business. On December 13, 2006, the Company announced that it had reached an agreement to sell Quilter (see Other Items Business and Other Acquisitions and Dispositions herein). The impact of Quilter to the Global Wealth Management Group's operating results for all periods presented was not material.

**Investment Banking.** Global Wealth Management Group investment banking includes revenues from the distribution of equity and fixed income securities, including initial public offerings, secondary offerings, closed-end funds and unit trusts. Revenues also include fees earned from offerings underwritten by the Institutional Securities business. Investment banking revenues increased 34% and 10% in fiscal 2006 and fiscal 2005, respectively. The increase in both periods was primarily due to higher revenues from equity-related offerings and unit trust products. The increase in fiscal 2005 was partially offset by lower revenues from fixed income underwritings.

**Principal Transactions Trading.** Principal transactions include revenues from customers' purchases and sales of financial instruments in which the Company acts as principal and gains and losses on the Company's inventory positions held, primarily to facilitate customer transactions. Principal transaction trading revenues increased 2% in fiscal 2006, primarily reflecting higher revenue from foreign exchange products, equity linked notes and municipal fixed income securities, partially offset by lower revenues from corporate and government fixed income products and other securities. In fiscal 2005, principal transaction trading revenues decreased 10%, primarily due to lower customer transaction activity in

corporate, government and municipal fixed income securities.

***Principal Transactions Investments.*** Principal transaction net investment revenues were \$53 million in fiscal 2006 compared with a net loss of \$(1) million in fiscal 2005 and a net loss of \$(5) million in fiscal 2004. The results in fiscal 2006 were primarily related to realized and unrealized gains on the Company's investments in Bolsas y Mercados Españoles (BME) and the NYSE.

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**Commissions.** Commission revenues primarily arise from agency transactions in listed and OTC equity securities and sales of mutual funds, futures, insurance products and options. Commission revenues decreased 2% and 7% in fiscal 2006 and fiscal 2005, respectively. The decrease in both fiscal years largely reflected lower revenues from equity products, which was related to lower agency activity with customers due, in part, to growth in other product areas, including investment banking and asset management.

**Net Interest.** Interest and dividend revenues and interest expense are a function of the level and mix of total assets and liabilities, including customer bank deposits and margin loans and securities borrowed and securities loaned transactions. Net interest revenues increased 52% and 28% in fiscal 2006 and fiscal 2005, respectively. The increase in fiscal 2006 was primarily due to increased customer account balances in the bank deposit program that was launched in November 2005. Balances in the bank deposit program rose to \$13,301 million at November 30, 2006 from \$1,689 million at November 30, 2005. The increase in net interest income in fiscal 2005 was primarily due to growth in customer margin balances.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees include revenues from individual investors electing a fee-based pricing arrangement and fees for investment management, account services and administration. The Company also receives fees for services it provides in distributing certain open-ended mutual funds and other products. Mutual fund distribution fees are based on either the average daily fund net asset balances or average daily aggregate net fund sales and are affected by changes in the overall level and mix of assets under management or supervision.

Asset management, distribution and administration fees increased 7% in fiscal 2006 and 20% in fiscal 2005. In both fiscal years, the increase was driven by higher client asset balances in fee-based accounts.

Client assets in fee-based accounts rose 19% to \$206 billion at November 30, 2006 and increased as a percentage of total client assets to 30% of total client assets from 28% in the prior year. Client assets in fee-based accounts rose 10% to \$173 billion at November 30, 2005 and increased as a percentage of total client assets to 28% of total client assets from 26% in the prior year. Client asset balances increased to \$686 billion at November 30, 2006 from \$617 billion at November 30, 2005, primarily due to market appreciation. Client asset balances in accounts greater than \$1 million increased to \$450 billion at November 30, 2006 from \$375 billion at November 30, 2005.

**Other.** Other revenues primarily include customer account service fees and other miscellaneous revenues. Other revenues decreased 7% in fiscal 2006 and increased 26% in fiscal 2005. In fiscal 2006, the decrease primarily reflected lower service fees. In fiscal 2005, the increase was primarily due to higher service fees and other miscellaneous revenues.

**Non-Interest Expenses.** Non-interest expenses increased 13% in fiscal 2006. Fiscal 2005 included a reduction in non-interest expenses related to Global Wealth Management Group's share (\$198 million) of the insurance settlement related to the events of September 11, 2001 (see Other Items Insurance Settlement herein). Compensation and benefits expense increased 15%, primarily reflecting higher incentive-based compensation costs. In addition, fiscal 2006 expenses included Global Wealth Management Group's share (\$50 million) of the incremental compensation expense related to equity awards to retirement-eligible employees, including new hires (see Other Items Stock-Based Compensation herein), while fiscal 2005 included Global Wealth Management Group's share (\$48 million) of the costs associated with senior management changes (see Other Items Senior Management Compensation Charges herein). Excluding compensation and benefits expense and the insurance settlement, non-interest expenses decreased 4%. Occupancy and equipment expense decreased 5%, 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 Other Items Lease Adjustment herein). Professional services expense increased 17%, largely due to higher sub-advisory fees associated with growth in fee-based assets and higher costs for outside legal counsel. Other expenses decreased 21%, primarily resulting from lower costs



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associated with legal and regulatory matters. During fiscal 2006 and fiscal 2005, the Company recorded legal and regulatory expenses of approximately \$105 million and \$170 million, respectively, related to ongoing regulatory, employment and branch litigation matters.

Non-interest expenses increased 4% in fiscal 2005 and included Global Wealth Management Group's share (\$198 million) of the insurance settlement related to the events of September 11, 2001. Excluding the insurance settlement, non-interest expenses increased 9% in fiscal 2005. Compensation and benefits expense increased 5%, reflecting higher incentive-based compensation costs and Global Wealth Management Group's share (\$48 million) of the costs associated with senior management changes. In addition, fiscal 2004 included a reduction in compensation expense of \$27 million associated with the change in the method of accounting for certain asset management and account fees (see Other Items Asset Management and Account Fees herein). Excluding compensation and benefits expense, non-interest expenses increased 3%. Occupancy and equipment expense increased 11%, primarily due to a \$29 million charge recorded in the first quarter of fiscal 2005 for the correction in the method of accounting for certain real estate leases. Information processing and communications expense increased 9%, primarily due to higher telecommunications costs within the branch network. Professional services expense increased 31%, largely due to higher sub-advisory fees associated with growth in fee-based assets and revenues, as well as higher outside legal counsel and consulting costs. Other expenses increased 16%, primarily due to costs associated with branch closings and higher legal and regulatory costs. In fiscal 2005, the Company recorded legal and regulatory expenses of approximately \$170 million, primarily related to employment matters and certain regulatory and branch litigation matters.

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

	Fiscal	Fiscal	Fiscal
	2006	2005	2004
	(dollars in millions)		
Revenues:			
Investment banking	\$ 48	\$ 50	\$ 43
Principal transactions:			
Investments	139	326	248
Commissions	25	29	27
Asset management, distribution and administration fees	2,504	2,460	2,390
Interest and dividends	45	23	8
Other	23	30	28
<b>Total revenues</b>	<b>2,784</b>	<b>2,918</b>	<b>2,744</b>
Interest expense	14	11	6
<b>Net revenues</b>	<b>2,770</b>	<b>2,907</b>	<b>2,738</b>
Total non-interest expenses	2,059	1,900	1,911
Income before taxes and cumulative effect of accounting change, net	711	1,007	827
Provision for income taxes	285	378	318
<b>Income before cumulative effect of accounting change, net</b>	<b>\$ 426</b>	<b>\$ 629</b>	<b>\$ 509</b>

**Investment Banking.** Asset Management generates investment banking revenues primarily from the underwriting of unit trust products. Investment banking revenues decreased 4% in fiscal 2006 and increased 16% in fiscal 2005. The decrease in fiscal 2006 primarily reflected a lower volume of fixed income unit trust sales, partially offset by higher equity unit trust sales, which generate lower revenues in comparison with fixed income unit trust sales. The increase in fiscal 2005 was primarily due to a higher volume of unit trust sales. Unit trust sales volume increased 20% to \$7.3 billion in fiscal 2006 and increased 11% to \$6.1 billion in fiscal 2005.

**Principal Transactions-Investments.** Asset Management principal transaction investment revenues consist primarily of gains and losses on investments associated with the Company's private equity activities and capital investments in certain of the Company's investment funds, primarily in alternative products.

Principal transaction net investment gains aggregating \$139 million were recognized in fiscal 2006 as compared with \$326 million in fiscal 2005. The results in both fiscal years primarily reflected net investment gains on certain investments in the Company's private equity portfolio, including Aventine Renewable Energy Holdings, LLC. Fiscal 2005's results also included a net investment gain on Triana Energy Holdings, LLC.

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Private equity investments generally are held for appreciation. It is not possible to determine when the Company will realize the value of such investments since, among other factors, such investments generally are subject to significant sales restrictions. Moreover, estimates of the fair value of the investments involve significant judgment and may fluctuate significantly over time in light of business, market, economic and financial conditions generally or in relation to specific transactions.

**Commissions.** Asset Management primarily generates commission revenues from dealer and distribution concessions on sales of certain funds. Commission revenues decreased 14% in fiscal 2006 and increased 7% in fiscal 2005. The decrease in fiscal 2006 was primarily due to a decrease in commissionable sales of certain fund products, while fiscal 2005 reflected an increase in such commissionable sales.



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**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees primarily include revenues from the management and supervision of assets, including fees for distributing certain open-ended mutual funds, shareholder servicing fees and management fees associated with the Company's private equity activities. These fees arise from investment management services the Company provides to investment vehicles pursuant to various contractual arrangements. The Company receives fees primarily based upon mutual fund daily average net assets or quarterly assets for other vehicles.

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

	At November 30,			Average for		
	2006	2005(1)	2004(1)	Fiscal 2006	Fiscal 2005(1)	Fiscal 2004(1)
(dollars in billions)						
<b>Assets under management or supervision by distribution channel:</b>						
Americas Retail Morgan Stanley brand	\$ 57	\$ 62	\$ 67	\$ 59	\$ 64	\$ 66
Americas Retail Van Kampen brand	94	88	79	90	84	75
Americas Intermediary(2)	63	48	47	55	45	41
U.S. Institutional	88	87	89	87	88	86
Non-U.S.	88	67	59	77	62	53
<b>Total long-term assets under management or supervision</b>	<b>390</b>	<b>352</b>	<b>341</b>	<b>368</b>	<b>343</b>	<b>321</b>
Institutional money markets/liquidity	49	33	31	39	33	18
Retail money markets	35	46	52	40	49	51
<b>Total money markets</b>	<b>84</b>	<b>79</b>	<b>83</b>	<b>79</b>	<b>82</b>	<b>69</b>
<b>Total assets under management or supervision</b>	<b>474</b>	<b>431</b>	<b>424</b>	<b>447</b>	<b>425</b>	<b>390</b>
Share of minority interest assets(3)	4					
<b>Total</b>	<b>\$ 478</b>	<b>\$ 431</b>	<b>\$ 424</b>	<b>\$ 447</b>	<b>\$ 425</b>	<b>\$ 390</b>
<b>Assets under management or supervision by asset class:</b>						
Equity	\$ 239	\$ 218	\$ 198	\$ 228	\$ 207	\$ 183
Fixed income	94	91	104	91	96	103
Money market	84	79	83	79	82	69
Alternative investments	21	19	19	20	19	18
Real estate	22	12	9	16	10	7
<b>Subtotal</b>	<b>460</b>	<b>419</b>	<b>413</b>	<b>434</b>	<b>414</b>	<b>380</b>
Unit trusts	14	12	11	13	11	10
<b>Total assets under management or supervision</b>	<b>474</b>	<b>431</b>	<b>424</b>	<b>447</b>	<b>425</b>	<b>390</b>
Share of minority interest assets(3)	4					
<b>Total</b>	<b>\$ 478</b>	<b>\$ 431</b>	<b>\$ 424</b>	<b>\$ 447</b>	<b>\$ 425</b>	<b>\$ 390</b>

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

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

(3) Amount represents Asset Management's proportional share of assets managed by entities in which it owns a minority interest.



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Activity in Asset Management's customer assets under management or supervision during fiscal 2006 and fiscal 2005 were as follows:

	Fiscal	Fiscal
	2006	2005
	(dollars in billions)	
<b>Balance at beginning of period</b>	\$ 431	\$ 424
Net flows by distribution channel:		
Americas Retail Morgan Stanley brand	(10)	(11)
Americas Retail Van Kampen brand	(2)	3
Americas Intermediary(1)	9	(2)
U.S. Institutional	(14)	(12)
Non-U.S.	5	7
Net outflows excluding money markets	(12)	(15)
Money market net flows:		
Institutional	13	3
Retail	(13)	(7)
Total money market net flows		(4)
Net market appreciation	55	26
Total net increase	43	7
Net increase in share of minority interest assets(2)	4	
<b>Balance at end of period</b>	\$ 478	\$ 431

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

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

Net outflows (excluding money markets) in fiscal 2006 were primarily associated with the Company's U.S. Institutional products and Americas Retail Morgan Stanley branded products, partially offset by positive flows into Americas Intermediary products. For fiscal 2006, positive flows into institutional liquidity assets were offset by outflows from certain money market funds that were impacted by the growth of the Global Wealth Management Group's bank deposit program.

Asset management, distribution and administration fees increased 2% in fiscal 2006 and 3% in fiscal 2005. The increase in both periods was due to higher management and administration fees, partially offset by lower distribution fees. The higher management and administration fees in fiscal 2006 and fiscal 2005 were associated with increases in average assets under management of 5% and 9%, respectively.

**Non-Interest Expenses.** Non-interest expenses increased 8% in fiscal 2006. Fiscal 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 Other Items Insurance Settlement herein). Compensation and benefits expense increased 22% in fiscal 2006, primarily reflecting higher incentive-based compensation costs as well as the impact of new hires. In addition, fiscal 2006 included Asset Management's share (\$20 million) of the incremental compensation expense related to equity awards to retirement-eligible employees (see Other Items Stock-Based Compensation herein), while fiscal 2005 included Asset Management's share (\$41 million) of the costs associated with senior management changes (see Other Items Senior Management Compensation Charges herein). Excluding compensation and benefits expense and the insurance settlement, non-interest expenses

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decreased 4%. Brokerage, clearing and exchange fees decreased 14%, 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 11%, primarily due to higher advertising and marketing costs.

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Fiscal 2005's total non-interest expenses decreased 1%, including Asset Management's share (\$43 million) of the insurance settlement related to the events of September 11, 2001. Excluding the insurance settlement, non-interest expenses increased 2%. Compensation and benefits expense increased 9%, primarily reflecting higher incentive-based compensation costs due to higher net revenues and Asset Management's share (\$41 million) of the costs associated with senior management changes. Brokerage, clearing and exchange fees decreased 7%, 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 19%, primarily due to higher promotional costs associated with the Company's Van Kampen products. Professional services expense increased 6% due to higher sub-advisory fees, partially offset by lower legal and consulting fees. Other expenses decreased 20%, primarily due to a reduction in legal reserves resulting from the resolution of certain legal matters, partially offset by higher insurance expense.

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## DISCOVER

## INCOME STATEMENT INFORMATION

	Fiscal	Fiscal	Fiscal
	2006	2005	2004
	(dollars in millions)		
Merchant, cardmember and other fees, net	\$ 1,167	\$ 1,323	\$ 1,317
Servicing and securitization income	2,338	1,609	1,921
Other revenue	35	5	10
Total non-interest revenues	3,540	2,937	3,248
Interest revenue	2,458	2,174	1,859
Interest expense	952	781	648
Net interest income	1,506	1,393	1,211
Provision for consumer loan losses	756	878	926
Net credit income	750	515	285
Net revenues	4,290	3,452	3,533
Total non-interest expenses	2,703	2,531	2,312
Income before losses from unconsolidated investees, income taxes and cumulative effect of accounting change, net	1,587	921	1,221
Losses from unconsolidated investees	3		
Provision for income taxes	506	340	443
Income before cumulative effect of accounting change, net	\$ 1,078	\$ 581	\$ 778

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover (see [Other Items](#) [Discover Spin-off](#) herein).

**Merchant, Cardmember and Other Fees, Net.** Merchant, cardmember and other fees, net, 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 processing 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. Cardmember rewards include various reward programs, including the Cashback Bonus® 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.

In fiscal 2006, Merchant, cardmember and other fees, net, decreased 12%, primarily due to higher cardmember rewards and lower merchant discount revenues, partially offset by higher cardmember and other fees. The increase in cardmember rewards reflected record sales volume and

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the impact of promotional programs. The decrease in 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 allocated interchange revenue to new securitization transactions, which has the effect of decreasing Merchant, cardmember and other fees, net, and increasing Servicing and securitization income. During fiscal 2006, the Company had a higher level of outstanding securitization transactions receiving interchange revenue allocations than in the prior year. The increase in sales volume reflected increased cardmember usage and the acquisition of Goldfish in February 2006 (see Other Items Business and Other Acquisitions and Dispositions herein). The increase in cardmember and other fees was primarily related to higher balance transfer fees, lower fee net charge-offs and higher credit protection fees.

In fiscal 2005, Merchant, cardmember and other fees, net, were relatively unchanged as higher transaction processing revenues were offset by higher net cardmember rewards. The increase in transaction processing

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revenues was related to the acquisition of PULSE on January 12, 2005 (see Other Items Business and Other Acquisitions and Dispositions herein). The increase in net cardmember rewards reflected record sales volume and the impact of promotional programs.

**Servicing and Securitization Income.** Servicing and securitization income is revenue derived from consumer loans that have been sold to investors through asset securitizations. Cash flows from the interest yield and cardmember fees generated by securitized general purpose credit card loans as well as interchange fees for certain securitization transactions are used to pay investors in these loans a predetermined fixed or floating rate of return on their investment, to reimburse investors for losses of principal resulting from charged-off loans and to pay the Company a fee for servicing the loans ( servicing rights ). Any excess cash flows remaining ( excess servicing rights ) are paid to the Company. The sale of general purpose credit card loans through asset securitizations, therefore, has the effect of converting portions of net credit income and fee income to servicing and securitization income.

Included in Servicing and securitization income are revenues from servicing rights, excess servicing rights and gains or losses on general purpose credit card asset securitizations as well as the change in the fair value of the Company's retained interests in general purpose credit card asset securitizations.

The table below presents the components of Servicing and securitization income:

	Fiscal	Fiscal	Fiscal
	2006	2005	2004
	(dollars in millions)		
Merchant, cardmember and other fees, net	\$ 1,014	\$ 694	\$ 650
Other revenue	159	(78)	(8)
<b>Total non-interest revenues</b>	<b>1,173</b>	<b>616</b>	<b>642</b>
Interest revenue	3,709	3,530	3,842
Interest expense	1,398	1,025	692
Net interest income	2,311	2,505	3,150
Provision for consumer loan losses	1,146	1,512	1,871
Net credit income	1,165	993	1,279
<b>Servicing and securitization income</b>	<b>\$ 2,338</b>	<b>\$ 1,609</b>	<b>\$ 1,921</b>

Servicing and securitization income is affected by the level of securitized loans, the spread between the net interest yield on the securitized loans and the yield paid to the investors, the rate of credit losses on securitized loans and the level of merchant, cardmember and other fees earned. The Other revenue component of Servicing and securitization income includes net securitization gains and losses on general purpose credit card loans and the change in the fair value of the Company's retained interests in general purpose credit card asset securitizations.

Servicing and securitization income increased 45% in fiscal 2006, primarily due to a lower Provision for consumer loan losses, higher Merchant, cardmember and other fees, net, and higher Other revenue, partially offset by lower net interest revenues. The lower Provision for consumer loan



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losses 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 Merchant, cardmember and other fees, net, primarily reflected a higher level of outstanding securitization transactions that received interchange revenues. The increase in Other revenue was attributable to an increase in the fair value of the Company's retained interests in securitized receivables, primarily resulting from a continued favorable impact on charge-offs following the enactment of federal bankruptcy legislation effective in October 2005. The increase in Other revenue also reflected higher levels of general purpose credit card securitization transactions and a decrease in

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net gain amortization related to prior securitization transactions. The decrease in net interest revenues was primarily attributable to a lower net interest spread and a lower level of average securitized general purpose credit card loans.

In fiscal 2005, Servicing and securitization income decreased 16%, reflecting lower net interest revenues and Other revenue, partially offset by a lower Provision for consumer loan losses and higher Merchant, cardmember and other fees, net. The decrease in net interest revenues was attributable to a lower level of average securitized general purpose credit card loans and a higher weighted average coupon rate paid to investors associated with the higher short-term interest rate environment. The interest yield was relatively unchanged from fiscal 2004 as the impact of the increase in the prime rate was offset by a decline in higher rate loans due to improved credit quality and various pricing initiatives. The decrease in Other revenue was primarily due to a lower level of securitized receivables and a decline in the fair value of the Company's retained interests in securitized receivables as a result of an increase in bankruptcy notifications and its impact on future charge-offs. The lower Provision for consumer loan losses was primarily attributable to a lower rate of net principal charge-offs related to the securitized general purpose credit card loan portfolio and a lower level of average securitized general purpose credit card loans, partially offset by an increase in bankruptcy charge-offs. The increase in Merchant, cardmember and other fees, net, reflected the allocation of interchange revenue to certain securitization transactions and lower fee net charge-offs, partially offset by lower assessed late payment and overlimit fees.

The net proceeds received from general purpose credit card asset securitizations were \$8,738 million in fiscal 2006 and \$7,240 million in fiscal 2005. The credit card asset securitization transactions completed in fiscal 2006 have expected maturities ranging from approximately three to seven years from the date of issuance.

***Net Interest Income.*** Net interest income represents the difference between interest revenue derived from consumer loans and short-term investment assets and interest expense incurred to finance those loans and assets. Assets, consisting primarily of consumer loans, currently earn interest revenue at both fixed rates and market-indexed variable rates. The Company incurs interest expense at fixed and floating rates. Interest expense also includes the effects of any interest rate contracts entered into by the Company as part of its interest rate risk management program. This program is designed to reduce the volatility of earnings resulting from changes in interest rates by having a financing portfolio that reflects the existing repricing schedules of consumer loans as well as the Company's right, with notice to cardmembers, to reprice certain fixed rate consumer loans to a new interest rate in the future.

Net interest income increased 8% in fiscal 2006 due to an increase in Interest revenue, partially offset by an increase in Interest expense. The increase in Interest revenue was due to an increase in average owned general purpose credit card loans and a higher interest yield. The increase in average owned general purpose credit card loans was due to the acquisition of Goldfish, record sales volume and a lower level of average securitized general purpose credit card loans. The increase in Interest expense was primarily related 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.

Net interest income increased 15% in fiscal 2005 due to an increase in Interest revenue, partially offset by an increase in Interest expense. The increase in Interest revenue was primarily due to an increase in average general purpose credit card loans, which was partly attributable to a higher level of securitization maturities and the deferment of new securitization transactions due to the exploration of the potential spin-off of Discover in fiscal 2005. The increase in Interest expense was largely due to a higher level of average interest bearing liabilities, primarily to support the increase in average general purpose credit card loans.

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The following tables present analyses of Discover's average balance sheets and interest rates in fiscal 2006, fiscal 2005 and fiscal 2004 and changes in net interest income during those fiscal years:

**Average Balance Sheet Analysis.**

	Fiscal 2006			Fiscal 2005			Fiscal 2004		
	Average Balance	Rate	Interest	Average Balance	Rate	Interest	Average Balance	Rate	Interest
<b>ASSETS</b>									
Interest earning assets:									
General purpose credit card loans	\$ 21,647	10.39%	\$ 2,248	\$ 19,932	10.12%	\$ 2,017	\$ 17,608	10.05%	\$ 1,770
Other consumer loans	185	7.32	14	364	7.64	28	427	8.14	35
Investment securities	60	3.99	2	52	1.86	1	40	1.92	1
Other	3,654	5.30	194	3,426	3.74	128	2,526	2.11	53
Total interest earning assets	25,546	9.62	2,458	23,774	9.15	2,174	20,601	9.02	1,859
Allowance for loan losses	(802)			(864)			(972)		
Non-interest earning assets	2,629			2,479			2,343		
Total assets	\$ 27,373			\$ 25,389			\$ 21,972		
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>									
Interest bearing liabilities:									
Interest bearing deposits:									
Savings	\$ 1,710	4.86%	\$ 83	\$ 691	2.89%	\$ 20	\$ 688	1.05%	\$ 7
Brokered	10,920	4.68	511	11,639	4.38	510	8,601	5.07	436
Other time	1,665	4.57	76	2,190	3.71	81	2,154	3.33	72
Total interest bearing deposits	14,295	4.69	670	14,520	4.21	611	11,443	4.50	515
Other borrowings	5,536	5.09	282	4,131	4.10	170	4,247	3.14	133
Total interest bearing liabilities	19,831	4.80	952	18,651	4.19	781	15,690	4.13	648
Shareholder's equity/other liabilities	7,542			6,738			6,282		
Total liabilities and shareholder's equity	\$ 27,373			\$ 25,389			\$ 21,972		
Net interest income			\$ 1,506			\$ 1,393			\$ 1,211
Net interest margin(1)			5.90%			5.86%			5.88%
Interest rate spread(2)		4.82%			4.96%			4.89%	

(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.

**Table of Contents****Rate/Volume Analysis.**

Increase/(Decrease) due to Changes in:	Fiscal 2006 vs. Fiscal 2005			Fiscal 2005 vs. Fiscal 2004		
	Volume	Rate	Total	Volume	Rate	Total
<b>Interest Revenue</b>						
General purpose credit card loans	\$ 174	\$ 57	\$ 231	\$ 233	\$ 14	\$ 247
Other consumer loans	(14)		(14)	(5)	(2)	(7)
Investment securities		1	1			
Other	9	57	66	19	56	75
Total interest revenue	162	122	284	285	30	315
<b>Interest Expense</b>						
Interest bearing deposits:						
Savings	29	34	63		13	13
Brokered	(32)	33	1	154	(80)	74
Other time	(19)	14	(5)	1	8	9
Total interest bearing deposits	(9)	68	59	138	(42)	96
Other borrowings	58	54	112	(3)	40	37
Total interest expense	49	122	171	122	11	133
Net interest income	\$ 113	\$	\$ 113	\$ 163	\$ 19	\$ 182

**Provision for Consumer Loan Losses.** The Provision for consumer loan losses is the amount necessary to establish the allowance for consumer loan losses at a level that the Company believes is adequate to absorb estimated losses in its consumer loan portfolio at the balance sheet date. The allowance for consumer loan losses is a significant estimate that represents management's estimate of probable losses inherent in the owned consumer loan portfolio. The allowance for consumer loan losses is primarily applicable to the owned homogeneous consumer credit card loan portfolio. The allowance is evaluated quarterly for adequacy and is established through a charge to the Provision for consumer loan losses. In estimating 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 credit losses, 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.

The Company's provision for consumer loan losses was \$756 million, \$878 million and \$926 million for fiscal 2006, fiscal 2005 and fiscal 2004, respectively. The Company's allowance for consumer loan losses was \$831 million at November 30, 2006 and \$838 million at November 30, 2005.

The provision for consumer loan losses decreased 14% in fiscal 2006. The decrease reflected lower net charge-offs and a lower net reduction of reserves as compared with the prior year. The decrease in net charge-offs primarily reflected a decline in bankruptcy filings following the federal bankruptcy legislation effective in October 2005 and improved portfolio credit quality. The net reduction in reserves in fiscal 2006 was approximately \$71 million as compared with approximately \$100 million in the prior year.

In fiscal 2005, the provision for consumer loan losses decreased 5%, primarily due to a higher net reduction of reserves and lower net charge-offs as compared with fiscal 2004 due to improvement in credit quality in the

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Company's consumer loan portfolio, partially offset by the impact of higher bankruptcy filings in advance of the new U.S. bankruptcy legislation effective in October 2005. The net reduction in reserves in fiscal 2005 totaled approximately \$100 million as compared with a net reduction of approximately \$60 million in fiscal 2004.

***Delinquencies and Charge-offs.*** General purpose credit card loans are considered delinquent when contractual payments become 30 days past due. General purpose credit card loans generally are charged off at the end of the month during which an account becomes 180 days contractually 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. Loan delinquencies and charge-offs are affected by changes in economic conditions, account collection management and policy changes and may vary throughout the year due to seasonal consumer spending and payment behaviors.

Delinquency rates in both the over 30-day and over 90-day categories and net principal charge-off rates were lower for both the owned and managed portfolios in fiscal 2006, reflecting strong portfolio credit quality and the continued favorable impact following federal bankruptcy legislation effective in fiscal 2005 (see *Managed General Purpose Credit Card Loan Data* herein). While credit costs are expected to continue to rise, the Company expects charge-off rates to remain relatively low and reach between 4.5% and 5.0% by the end of fiscal 2007.

In fiscal 2005, delinquency rates in both the over 30-day 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 (see *Managed General Purpose Credit Card Loan Data* herein). The improvement in net principal charge-off rates was partially offset by an increase in bankruptcy charges-offs related to consumers filing for bankruptcy in advance of the new U.S. bankruptcy legislation effective in October 2005.

In response to industry-wide regulatory guidance, the Company has increased minimum payment requirements on certain general purpose credit card loans. 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. Increases in minimum payment requirements could negatively impact future levels of general purpose credit card loans and related interest and fee revenue and charge-offs.

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, regulatory changes or new guidance, 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 7% in fiscal 2006. Compensation and benefits expense increased 7% and included Discover's share (\$10 million) of the incremental compensation expense related to equity awards to retirement-eligible employees (see *Other Items Stock-Based Compensation* herein) as well as an increase in salaries and wages. Fiscal 2005 included Discover's share (\$29 million) of the costs associated with senior management changes (see *Other Items Senior Management Compensation Charges* herein). Information processing and communications expense increased 10%, primarily due to higher data and transaction processing costs related to the acquisition of Goldfish in February 2006. Marketing and business development expense increased 3% due to increased marketing costs associated with account



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acquisitions, the launch of the Discover Business Card and higher advertising expenses due to the branding campaign launched at the end of the third quarter of fiscal 2006. Professional services expense increased 25% due to higher legal fees and investments in infrastructure and technology.

Fiscal 2005's non-interest expenses increased 9% from fiscal 2004, partially resulting from the acquisition of PULSE (see Other Items Business and Other Acquisitions and Dispositions herein). Compensation and benefits expense increased 15%, including Discover's share (\$29 million) of the costs associated with senior management changes, as well as an increase in personnel costs, including salaries and benefits. Excluding compensation and benefits expense, non-interest expenses increased 7%. Marketing and business development expense increased 2% due to increased marketing and advertising costs. Professional services expense increased 12% due to higher consulting fees, partially related to the exploration of the potential spin-off of Discover in fiscal 2005 and an increase in legal and account collection fees. Other expenses increased 16%, primarily reflecting an increase in certain operating expenses, including accruals for losses associated with cardmember fraud and higher legal accruals.

**Seasonal Factors.** Discover's activities are affected by seasonal patterns of retail purchasing. Historically, a substantial percentage of general purpose credit card loan growth occurs in the fourth calendar quarter, followed by a flattening or decline of these loans in the following calendar quarter. Merchant fees, therefore, historically have tended to increase in the first fiscal quarter, reflecting higher sales activity in the month of December. Additionally, higher cardmember rewards incentives historically have been accrued for as a reduction of merchant and cardmember fee revenues in the first fiscal quarter, reflecting seasonal growth in retail sales volume.

**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 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)**

	Fiscal 2006				Fiscal 2005				Fiscal 2004			
	Average Balance	Return on Receivables(1)	Interest Yield	Interest Rate Spread	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 Credit Card Loans:</b>												
Owned	\$ 21,647	4.98%	10.39%	5.59%	\$ 19,932	2.92%	10.12%	5.94%	\$ 17,608	4.43%	10.05%	5.92%
Securitized	26,560	4.06%	13.96%	8.69%	27,398	2.12%	12.88%	9.16%	29,779	2.62%	12.90%	10.56%



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Managed	\$ 48,207	2.24%	12.36%	7.29%	\$ 47,330	1.23%	11.72%	7.81%	\$ 47,387	1.65%	11.84%	8.88%
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(1) Return on receivables is equal to Discover income divided by average owned, securitized or managed credit card receivables, as applicable.

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The following tables present a reconciliation of owned and managed general purpose credit card loans and delinquency and net charge-off rates:

**Reconciliation of General Purpose Credit Card Loan Asset Quality Data (dollars in millions)**

	Fiscal 2006 Delinquency Rates			Fiscal 2005 Delinquency Rates			Fiscal 2004 Delinquency Rates		
	Period- End Loans	Over 30 Days	Over 90 Days	Period- End Loans	Over 30 Days	Over 90 Days	Period- End Loans	Over 30 Days	Over 90 Days
<b>General Purpose Credit Card Loans:</b>									
Owned	\$ 23,588	3.22%	1.53%	\$ 22,496	3.69%	1.62%	\$ 19,724	4.08%	1.97%
Securitized	26,703	3.76%	1.75%	24,440	4.24%	1.87%	28,537	4.87%	2.34%
Managed	\$ 50,291	3.51%	1.65%	\$ 46,936	3.98%	1.75%	\$ 48,261	4.55%	2.18%

	Fiscal 2006	Fiscal 2005	Fiscal 2004
<b>Net Principal Charge-offs:</b>			
Owned	3.79%	4.84%	5.53%
Securitized	4.31%	5.52%	6.28%
Managed	4.08%	5.23%	6.00%

	Fiscal 2006	Fiscal 2005	Fiscal 2004
<b>Net Total Charge-offs (inclusive of interest and fees):</b>			
Owned	5.15%	6.59%	7.68%
Securitized	6.15%	7.72%	9.01%
Managed	5.70%	7.25%	8.51%

**Table of Contents****Other Items.****Staff Accounting Bulletin No. 108.**

In September 2006, the Securities and Exchange Commission ( SEC ) released Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 )*. SAB 108 permits the Company to adjust for the cumulative effect of errors relating to prior years in the carrying amount of assets and liabilities as of the beginning of the current fiscal year, with an offsetting adjustment to the opening balance of retained earnings in the year of adoption. SAB 108 also requires the adjustment of any prior quarterly financial statements within the fiscal year of adoption for the effects of such errors on the quarters when the information is next presented. Such adjustments do not require previously filed reports with the SEC to be amended. Effective August 31, 2006, the Company elected early application of SAB 108. In accordance with SAB 108, the Company has adjusted its opening retained earnings for fiscal 2006 and its financial results for the first two quarters of fiscal 2006 for the items described below. The Company considers these adjustments to be immaterial to prior annual periods.

**Trust Preferred Securities.** The Company adjusted its opening retained earnings for fiscal 2006 and its financial results for the first two quarters of fiscal 2006 to reflect a change in its hedge accounting under Statement of Financial Accounting Standards ( SFAS ) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended ( SFAS No. 133 ). The change is being made following a clarification by the SEC of its interpretation of SFAS No. 133 related to the accounting for fair value hedges of fixed-rate trust preferred securities.

Since January 2005, the Company entered into various interest rate swaps to hedge the interest rate risk inherent in its trust preferred securities. The terms of the interest rate swaps and the corresponding trust preferred securities mirrored one another, and the Company determined in the past that the changes in the fair value of the swaps and hedged instruments were the same. The Company applied the commonly used short-cut method in accounting for these fair value hedges and, therefore, did not reflect any gains or losses during the relevant periods. Based upon the SEC's clarification of SFAS No. 133, the Company determined that since it has the ability at its election to defer interest payments on its trust preferred securities, these swaps did not qualify for the short-cut method. These swaps performed as expected as effective economic hedges of interest rate risk. The Company ended hedging of the interest rate risk on these trust preferred securities effective August 2006 and adjusted its financial results as if hedge accounting was never applied. Prospectively, the Company will manage the interest rate risk on these securities as part of its overall asset liability management.

**Compensation and Benefits.** The Company also adjusted its opening retained earnings for fiscal 2006 and its financial results for the first two quarters of fiscal 2006 for two compensation and benefits accruals. Such accruals are related to (i) the overaccrual of certain payroll taxes in certain non-U.S. locations, primarily in the U.K., which arose in fiscal 2000 through fiscal 2006 and (ii) an adjustment to the amortization expense associated with stock-based compensation awards, which arose in fiscal 2003 and fiscal 2004.

**Impact of Adjustments.** The impact of each of the items noted above on fiscal 2006 opening Shareholders' equity and Retained earnings and on Net income for the first and second quarters of fiscal 2006 is presented below (dollars in millions):

Trust Preferred Securities	Non-U.S. Payroll Taxes	Amortization of Stock-Based Compensation Awards	Total
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Cumulative effect on Shareholders' equity as of December 1, 2005	\$ (84)	\$ 38	\$ 12	\$ (34)
Cumulative effect on Retained earnings as of December 1, 2005	\$ (84)	\$ 38	\$ (22)	\$ (68)
Effect on:				
Net income for the three months ended February 28, 2006	\$ (1)	\$ 14	\$	\$ 13
Net income for the three months ended May 31, 2006	\$ (116)	\$	\$	\$ (116)
Net income for the six months ended May 31, 2006	\$ (117)	\$ 14	\$	\$ (103)

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The aggregate impact of these adjustments is summarized below (dollars in millions, except per share data):

As of and for the Three Months Ended February 28, 2006	Previously		
	Reported	Adjustment	As Adjusted
Other assets	\$ 15,988	\$ 12	\$ 16,000
Other liabilities	\$ 14,984	\$ (98)	\$ 14,886
Long-term borrowings	\$ 121,395	\$ 131	\$ 121,526
Shareholders' equity	\$ 30,124	\$ (21)	\$ 30,103
Principal transactions trading revenue	\$ 3,067	\$ 13	\$ 3,080
Compensation and benefits expense	\$ 4,183	\$ (22)	\$ 4,161
Interest expense	\$ 9,481	\$ 15	\$ 9,496
Net income	\$ 1,561	\$ 13	\$ 1,574
Diluted EPS	\$ 1.47	\$ 0.01	\$ 1.48
Annualized return on common equity	21.1%	0.2%	21.3%

As of and for the Three Months Ended May 31, 2006	Previously		
	Reported	Adjustment	As Adjusted
Other assets	\$ 17,651	\$ 12	\$ 17,663
Other liabilities	\$ 18,159	\$ (162)	\$ 17,997
Long-term borrowings	\$ 127,985	\$ 311	\$ 128,296
Shareholders' equity	\$ 32,255	\$ (137)	\$ 32,118
Principal transactions trading revenue	\$ 3,735	\$ (170)	\$ 3,565
Compensation and benefits expense	\$ 3,723	\$	\$ 3,723
Interest expense	\$ 9,988	\$ 9	\$ 9,997
Net income	\$ 1,957	\$ (116)	\$ 1,841
Diluted EPS	\$ 1.86	\$ (0.11)	\$ 1.75
Annualized return on common equity	25.1%	(1.4)%	23.7%

For the Six Months Ended May 31, 2006	Previously		
	Reported	Adjustment	As Adjusted
Principal transactions trading revenue	\$ 6,802	\$ (157)	\$ 6,645
Compensation and benefits expense	\$ 7,906	\$ (22)	\$ 7,884
Interest expense	\$ 19,469	\$ 24	\$ 19,493
Net income	\$ 3,518	\$ (103)	\$ 3,415
Diluted EPS	\$ 3.33	\$ (0.10)	\$ 3.23
Annualized return on common equity	23.1%	(0.6)%	22.5%

**Stock-Based Compensation.**

The Company early adopted SFAS No. 123R, Share-Based Payment (SFAS No. 123R), 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 in fiscal 2005 by \$0.05.

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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.

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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 \$270 million in fiscal 2006 for stock-based awards granted to retirement-eligible employees as part of the fiscal 2005 year-end award process. These incremental expenses were included within Compensation and benefits expense and reduced income before taxes within the Institutional Securities (\$190 million), Global Wealth Management Group (\$50 million), Asset Management (\$20 million) and Discover (\$10 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 were 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 (which occurred in December 2006).

As a result, fiscal 2006 stock-based compensation expense primarily included the following costs:

amortization of fiscal 2003 year-end awards;

amortization of fiscal 2004 year-end awards;

amortization of fiscal 2005 year-end awards to non-retirement eligible employees;

the full cost of fiscal 2005 year-end awards to retirement eligible employees (made in December 2005); and

the full cost of fiscal 2006 year-end awards to retirement eligible employees (made in December 2006).

Fiscal 2007 stock-based compensation expense will primarily include the following costs:

amortization of fiscal 2004 year-end awards;

amortization of fiscal 2005 year-end awards to non-retirement eligible employees;

amortization of fiscal 2006 year-end awards to non-retirement eligible employees; and

the full cost of fiscal 2007 year-end awards to retirement eligible employees (expected to be made in December 2007).

Fiscal 2003 and fiscal 2004 year-end awards are generally amortized over three and four years, while fiscal 2005 and fiscal 2006 year-end awards are generally amortized over two and three years.

**Discontinued Operations.**

As described in Note 18 to the consolidated financial statements, 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" under the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144), and reported as discontinued operations in the Company's 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 fiscal 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 results for fiscal 2005 reflected a charge of \$509 million (\$316 million after-tax) to reflect the write-down of the aircraft leasing business to its estimated fair value in accordance with SFAS No. 144.



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In fiscal 2004, the Company entered into agreements for the sale of certain aircraft. Accordingly, the Company designated such aircraft as held for sale and recorded a \$42 million pre-tax loss related to the write-down of these aircraft to fair value in accordance with SFAS No. 144. As of February 3, 2005, all of these aircraft were sold. In addition, during fiscal 2004, the Company recorded aircraft impairment charges in accordance with SFAS No. 144.

The table below provides information regarding the pre-tax loss on discontinued operations and the aircraft impairment charges that are included in these amounts (dollars in millions):

	Fiscal Year		
	2006	2005	2004
Pre-tax loss from discontinued operations	\$ 42	\$ 486	\$ 172
Aircraft impairment charges			109

Fiscal 2006 reflected a net loss of \$25 million on discontinued operations, which included the results of operations of the aircraft leasing business through the date of sale. Fiscal 2005 and fiscal 2004 reflected a net loss on discontinued operations of \$302 million and \$103 million, respectively.

**Discover Spin-off.**

On December 19, 2006, the Company announced that its Board of Directors had approved the spin-off of Discover in order to enhance shareholder value. The Discover Spin-off will allow the Company to focus its efforts on more closely aligned firm-wide strategic priorities within its Institutional Securities, Global Wealth Management Group and Asset Management business segments. The Discover Spin-off is subject to regulatory approval and other customary conditions, and is expected to occur in the third quarter of fiscal 2007. At the time of the Discover Spin-off, shareholders of the Company will receive shares in Discover on a tax-free basis.

**Business and Other Acquisitions and Dispositions.***Subsequent to Fiscal 2006.*

**CityMortgage Bank.** On December 21, 2006, the Company acquired CityMortgage Bank ( CityMortgage ), a leading Moscow-based mortgage bank that specializes in originating, servicing and securitizing residential mortgage loans in the Russian Federation. The results of CityMortgage will be included within the Institutional Securities business segment.

**Olco Petroleum Group Inc.** On December 15, 2006, the Company acquired a 60% equity stake in Olco Petroleum Group Inc. ( Olco ), a petroleum products marketer and distributor based in eastern Canada. The results of Olco will be included within the Institutional Securities business segment.

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**Quilter.** On December 13, 2006, the Company announced that it had reached an agreement to sell Quilter, its standalone U.K. mass affluent business. The transaction is expected to close during the first quarter of fiscal 2007. The results of Quilter have been included within the Global Wealth Management Group business segment.

**Saxon Capital, Inc.** &n