MORGAN STANLEY SMITH BARNEY HOLDINGS (UK) LIMITED

Morgan Stanley

Pillar 3 *Disclosure*

As at 31 December 2012

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1. BASEL II ACCORD

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

The framework consists of three 'pillars'. Pillar 1 of the new standards sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors are required to assess the appropriateness of the Pillar 1 level of capital, taking into account risks not covered in Pillar 1, and must take action accordingly. The aim of Pillar 3 is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess certain specified information in relation to capital adequacy, particular risk exposures and risk management processes.

2. BACKGROUND TO PILLAR 3 DISCLOSURES

The ultimate parent undertaking and controlling entity of Morgan Stanley Smith Barney Holdings (UK) Limited ("MSSBH") and its subsidiary undertaking (together the "MSSBH UK Group") is Morgan Stanley, a Delaware corporation, which, together with its consolidated subsidiaries, form the Morgan Stanley Group ("Morgan Stanley Group"). Morgan Stanley is a "Financial Holding company" as defined by the Bank Holding Company Act of 1956, as amended, and is subject to regulation by the Board of Governors of the Federal Reserve System.

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

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

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

Public disclosures, including those required under Pillar 3 by the Financial Conduct Authority ("FCA"), will continue to evolve over time. The qualitative and quantitative information contained in this document represents the position of the MSSBH UK Group as at 31 December 2012. Amendments to the MSSBH UK Group's operating model and risk management procedures that have occurred following this date are not discussed in this document.

The majority of the numerical disclosures in this document are calculated by reference to the FCA's methodology for risk exposure and are not necessarily the primary exposure measures used by internal management. The calculation of exposure in this document is based on the calculation methodology for regulatory risk exposure prescribed in the FCA handbook. This document does not constitute a set of financial statements. The MSSBH UK Group's financial statements have been prepared in accordance with applicable United Kingdom ("UK") law and International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU"). Information disclosed in the MSSBH UK Group's financial statements will not necessarily be consistent with information disclosed in this document. Trading Book and Non Trading Book definitions used in this document refer to the regulatory view and may differ from the accounting definitions.

3. APPLICATION OF THE PILLAR 3 FRAMEWORK

This document represents the annual public Pillar 3 qualitative and quantitative disclosures required by the FCA Prudential Sourcebook for Banks, Building Societies and Investment Firms ("BIPRU") in relation to the MSSBH UK Group.

The basis of consolidation for prudential purposes is materially the same as consolidation for accounting purposes. The MSSBH UK Group completes its prudential consolidation in compliance with BIPRU8—Group risk consolidation. Morgan Stanley Private Wealth Management Limited ("MSPWM"), the sole subsidiary of MSSBH, is FCA regulated. This subsidiary undertaking is listed in the annual financial statements of the MSSBH UK Group, Company disclosures note 6. In this document references to annual financial statements refers to the audited financial statements for the year ended 31 December 2012.

The Company sold its investment in Quilter & Co. Limited ("Quilter") during the year and the branches in Ireland and Jersey, which the Group operated, were sold as part of this sale.

The MSSBH UK Group has a policy in place to assess the appropriateness of its Pillar 3 disclosures, including their verification and frequency.

4. MORGAN STANLEY SMITH BARNEY HOLDINGS (UK) LIMITED

The principal activity of the MSSBH UK Group is the provision of financial services to individual investors and corporations.

The FCA regulated MSSBH UK Group includes both entities that form part of the accounting consolidation group, MSSBH and MSPWM.

The MSSBH UK Group calculates capital requirements in accordance with the regulatory capital requirements of the FCA and, in turn, with guidelines described under the Basel II Accord.

5. CAPITAL RESOURCES

Under FCA supervision, the MSSBH UK Group is required to maintain a minimum ratio of total capital resources to capital requirements. The FCA handbook can be found at http://FCAhandbook.info/FCA/html/handbook/BIPRU.

All capital resources are included in Tiers 1 and 2 and are of standard form. The main terms and conditions of the capital instruments disclosed below are disclosed in the MSSBH UK Group's financial statement, see note 18 for subordinated loan disclosures and note 22 for equity share capital disclosures.

The table below shows the financial resources of the MSSBH UK Group as at 31 December 2012 based upon the audited financial statements.

Capital Resources Table

As at 31/12/2012	MSSBH UK Group 2012 $'000	MSSBH UK Group 2011 $'000
Permanent share capital	–	–
Profit and loss account and other reserves	(82,798)	12,489
Share premium account	180,551	180,551
Externally verified interim net profits[1]	134,914	–
Less: Intangible assets	(16,926)	(30,191)
Tier 1 capital after deductions	215,741	162,849
Tier 2 capital after deductions[2]	20,000	20,000
Less deductions from total capital	–	(40)
Total Capital Resources, After Deductions	**235,741**	**182,809**

[1] Externally verified interim net profits relate to the profits of the MSSBH UK solo company from 01 January 2012 – 30 June 2012, incorporating the sale of its investment in Quilter

[2] Tier 2 capital consists of subordinated loans

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

There are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities within the MSSBH UK Group.

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

6. REGULATORY CAPITAL REQUIREMENTS

The MSSBH UK Group calculates Pillar 1 capital requirements in accordance with the regulatory capital requirements of the FCA. As at 31 December 2012 the MSSBH UK Group had the following capital requirements:

Capital Requirements Table

As at end of December	MSSBH UK Group 2012 $'000	MSSBH UK Group 2011 $'000
Credit risk capital component	6,451	11,670
Counterparty risk capital component	-	71
Market risk capital requirement	195	3,152
Operational risk - basic indicator approach	17,639	34,175
Total variable capital requirement	**24,285**	**49,068**

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

The Market risk capital requirement reflects capital charges attributable to the risk of loss resulting from adverse changes in market prices and other factors. The market risk capital requirement of the MSSBH UK Group is determined using the standardised approach (see section 11 on Market Risk).

Operational risk capital charges are designed to account for the risk of losses due to inadequate or failed internal processes, people and systems, or external events and take into account legal risk. Capital requirements for operational risk are currently calculated using the Basic Indicator Approach ("BIA") (see section 12 on Operational Risk).

7. APPLICATION OF THE PILLAR 2 FRAMEWORK

The MSSBH UK Group employs a Required Capital Framework in order to meet its obligations under BIPRU 2.2 'Internal capital adequacy standards', whereby additional capital for stress losses is calculated and held. The Required Capital Framework is used to ensure that the MSSBH UK Group carries, or has access to, sufficient capital to support all material risks residing within the MSSBH UK Group, and is based on management's own risk assessment.

8. RISK MANAGEMENT OBJECTIVES AND POLICIES

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

As noted previously, Morgan Stanley is required to make quarterly filings with the SEC. For further discussion of Morgan Stanley's risk management objectives, policies and procedures, see pages 111-136 of 31 December 2012 Form 10-K.

9. ACCOUNTING POLICIES

The MSSBH UK Group's financial statements have been prepared in accordance with applicable UK law and IFRS as adopted by the EU. Further information regarding the accounting policies of MSSBH UK Group, including measurement considerations, can be found in note 3 of the notes to the consolidated financial statements of the MSSBH UK Group.

10. CREDIT RISK

10.1 Credit Exposure

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

The MSSBH UK Group's business is exposed to credit risk through margin lending to its MSPWM clients. The MSPWM margin loan book is housed on the UK broker dealer, Morgan Stanley & Co International plc ("MSIP"). The full business economics are transferred to MSPWM. Demand loans are callable with short notice periods. Proposed loans are subject to review and approval by the appropriate risk and credit committees. The MSSBH UK Group has dedicated staff to carry out its credit risk management in accordance with the direction set by the MSSBH UK Group's Risk Management and Firm Risk Management functions. There are strict controls around collateral management, including the type of collateral, collateral levels and legal title.

Policies on the impairment of financial and non-financial assets are in the MSSBH UK Group's financial statement notes to the consolidated financial statements, notes 3f and 3g. For accounting purposes at each reporting date an assessment is made as to whether there is any objective evidence of impairment in the value of a financial asset classified as either available-for-sale or loans and receivables. Impairment losses are recognised if an event has occurred which will have an adverse impact on the expected cash flows of an asset and the expected impact can be reliably estimated. Non-financial assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. There were no impaired exposures for the period reported, therefore no provisions were made for impaired exposures.

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

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

The FCA industry type is aligned with the classifications set out in BIPRU. Institutions include financial institutions and credit institutions. A standardised approach is used for all asset categories. The nominated external credit assessment institution ("ECAI") is Standard and Poor's ("S&P") which has been used for all standardised credit risk exposure classes.

The MSSBH UK Group is not exposed to counterparty risk as the MSSBH UK Group does not operate a trading book.

10.3 Credit Exposure Breakdown table

Standardised Approach Exposure Table

As at 31/12/2012	Credit Quality Step	Total Gross Exposure $'000	Total Exposure Value Covered by Eligible Financial Collateral $'000	Exposure Value after Credit Mitigation $'000	Credit Risk Capital Component $'000
Central Governments or Central Banks	1	81	-	81	-
Central Governments or Central Banks	6	60	60	-	-
Regional Governments or Local Authorities	2	3,532	3,516	16	1
Administrative Bodies & Non-Commercial Undertakings	3	247	-	247	20
Institutions	1	50,851	-	50,851	814
Institutions	2	191,914	-	191,914	3,071
Institutions	3	3,506	156	3,350	141
Institutions	4	3,756	-	3,756	287
Corporate	3	143,615	128,699	14,916	1,193
Collective investment undertakings	1	10,017	-	10,017	160
Collective investment undertakings	3	6,344	5,470	874	70
Other	3	615	-	615	694
Total		**414,538**	**137,901**	**276,637**	**6,451**

Gross credit exposure reported above is based on the regulatory definition as defined by the FCA on a product by product basis, prior to netting and collateral being applied, but after regulatory eliminations and exemptions are applied. Where appropriate this also includes prescribed haircuts. These exposures are therefore different to those presented in the MSSBH UK Group's financial statements. Exposures are consistent with regulatory returns.

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

Geographical breakdown of EAD

As at 31/12/2012	Americas $'000	EMEA $'000	Asia $'000	Total $'000
Central Governments or Central Banks	–	81	–	81
Regional Governments or Local Authorities	–	16	–	16
Administrative Bodies & Non-Commercial Undertakings	–	247	–	247
Institutions	109,293	140,194	384	249,871
Corporate	6,657	8,109	150	14,916
Collective Investment Undertakings	10,092	799	–	10,891
Other	–	615	–	615
Total	**126,042**	**150,061**	**534**	**276,637**

As well as assessing and monitoring its credit exposure and risk at the individual counterparty level, the MSSBH UK Group also reviews its credit exposure and risk to geographic regions. As at 31 December 2012, credit exposure was concentrated in North America and Western European countries. In addition, the Group pays particular attention to smaller exposures in emerging markets and exposures in Greece, Ireland, Italy, Portugal and Spain ("GIIPS") given their higher risk profile. Country ceiling ratings are derived using methodologies generally consistent with those employed by external rating agencies.

The Group also reviews its credit exposure and risk to types of customers. At 31 December 2012, the Group's material credit exposure was to corporate entities, financial institutions and collective investment undertakings.

10.4 Credit Risk Mitigation

The MSSBH UK Group applies a number of credit risk mitigation techniques, including netting and collateral.

Netting

The MSSBH UK Group has procedures in place for recording netting agreements with clients. Where credit is taken on MSSBH UK there is a process to review the legal enforceability of the relevant agreements, in some instances based on an assessment of the materiality of that risk. In instances where there is doubt over the legal enforceability of an agreement, the benefit of netting is not applied for the purposes of capital reporting. See the Standardised Approach Exposure table in section 10.3 for the impact of netting and collateral.

Collateral

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

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

Collateralised EAD relates to margin loans that are callable on demand. Unsecured EAD relates mainly to cash balances and intercompany receivable balances. All EAD has a maturity less than one year.

11. MARKET RISK

Sound market risk management is an integral part of the Morgan Stanley Group's culture. The business units are responsible for ensuring that market risk exposures are well managed and prudent. The control groups help ensure that these risks are measured and closely monitored and are made transparent to senior management. The Market Risk department is responsible for ensuring transparency of material market risks, monitoring compliance with established limits and escalating risk concentrations to appropriate senior management.

11.1 Market Risk in the Non-trading Book

The MSSBH UK Group has foreign currency exposure arising from its branches that operate in currencies other than US dollars. The majority of the foreign currency risk has been hedged by other members of Morgan Stanley Group, primarily Morgan Stanley, by utilising both forward foreign currency exchange contracts and non-US dollar denominated debt. For the MSSBH UK Group, typically, margin lending is matched with intercompany resulting in little direct market risk.

11.2 Interest Rate Risk in the Non-trading Book

The MSSBH UK Group is exposed to minimal interest rate risk as a result of deposits with highly rated banks. All deposits are on demand and therefore short term in nature.

12. OPERATIONAL RISK

12.1 Overview

Operational risk is defined as the risk of loss, or damage to Morgan Stanley's reputation, resulting from inadequate or failed processes, people and systems or from external events. This definition includes legal risk, but excludes strategic risk. Effective operational risk management reduces the likelihood or impact of operational incidents and mitigates legal, compliance, regulatory, franchise and reputational risks.

The MSSBH UK Group may incur operational risk across its full scope of business activities, including revenue generating activities (e.g. advisory and discretionary activities) and support functions (e.g. information technology and facilities management). The Operational Risk Department works with Business Units and Control Groups to ensure a transparent, consistent, and comprehensive framework for managing operational risk across MSSBH UK Group.