WRITTEN SUBMISSION OF MORGAN STANLEY
TO THE FINANCIAL CRISIS INQUIRY COMMISSION
JOHN J. MACK, CHAIRMAN

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Chairman Angelides, Vice Chairman Thomas, and distinguished Commissioners, thank you for the opportunity to appear before you today. My name is John Mack and I am the current Chairman of Morgan Stanley and also served as Chief Executive of the Firm from June 2005 through the end of 2009. President Obama and the United States Congress have asked this Commission to examine the causes of the recent financial crisis. We at Morgan Stanley are pleased to help you with this important task.

The past two years have been unlike any we have seen before in the financial services industry. Amidst unprecedented illiquidity and turmoil, Wall Street saw the fall of two storied franchises and the consolidation of others. We saw credit markets seize, the competitive landscape reshaped, and vast governmental intervention in the financial sector.

We at Morgan Stanley believe the financial crisis exposed fundamental flaws in our financial system. In retrospect, many firms were too highly leveraged, took on too much risk and did not have sufficient resources to manage those risks effectively in a rapidly changing environment. The financial crisis has also made it clear that regulators simply didn't have the visibility, tools or authority to protect the stability of the financial system as a whole.
Certainly no firm on Wall Street, including Morgan Stanley, anticipated the full dimension of the financial crisis. However, in late 2007 and early 2008 we recognized the need to adapt our business model to the new environment—and we began reducing leverage, trimming our balance sheet, raising private capital, and further strengthening our risk management abilities. These

early actions proved critically important in helping Morgan Stanley navigate the most challenging market shocks of the fall of 2008. Since then we have continued to adapt our business model by further diversifying our revenue and funding mix to create an ever more stable foundation for our business.

The Commission has requested that we address a number of topics in this written submission. I will attempt to address those topics in turn, by (1) providing an overview of Morgan Stanley's business model, including our organizational structure and major sources of income and revenue; (2) describing the financial challenges that we encountered during the financial crisis, the causes of those challenges, and Morgan Stanley's responses; and (3) discussing in greater detail some of the specific business practices and policies that Morgan Stanley has changed in response to the crisis, including those areas of particular interest to the Commission such as lending activities, risk management structure, and executive compensation practices, among others.

I. Morgan Stanley's Business Model

A. Overview

Morgan Stanley is a global financial services firm that provides products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions, and individuals. Since Morgan Stanley opened its doors in New York City in 1935, it has evolved into one of the world's foremost financial institutions, with more than 60,000 employees in 1,200 offices in 36 countries. In contrast to some of the other leading U.S. financial institutions, whose businesses include significant retail banking and lending operations, Morgan Stanley's business model has historically focused primarily on providing financial advisory and capital-raising services to institutional and corporate clients, with individual services principally in the wealth management sector through brokerage services.

Morgan Stanley now maintains significant market positions in each of our three principal business segments—Institutional Securities, Global Wealth Management, and Asset Management.

Institutional Securities. Morgan Stanley has a leading franchise in its Institutional Securities business, which provides financial advice and capital-raising services to a diverse group of corporate and institutional clients globally. This business offers advisory services on key strategic matters such as mergers or joint ventures, manages and participates in public offerings and private placements of debt and equity worldwide, and provides loans and lending commitments to select corporate clients. The Institutional Securities business also conducts sales, trading, financing and market-making activities on securities and futures exchanges and in over-the-counter markets around the world.

The Institutional Securities business has been active in helping companies access the capital markets to fund their businesses and economic growth. Since the beginning of the fourth quarter of 2008, we have helped clients—including leading American companies like Pepsi, Microsoft and Time Warner Cable—raise $708.7 billion in debt to invest in their businesses. During the same period we also helped clients raise $231.4 billion in equity to fund their businesses, including major capital raises for Ford Motor Co. and a wide range of financial services companies including US Bancorp, BB&T and State Street. We also made $45 billion in new money commitments for commercial loans to clients from October 2008 through November 2009.

Global Wealth Management. Morgan Stanley's Global Wealth Management business offers comprehensive financial services to individual investors and small-to-medium sized businesses and institutions. This group provides clients with a broad array of financial solutions, including Morgan Stanley's brokerage, investment advisory, and cash management services, along with products and services from third parties such as insurance companies and mutual fund families. This past year, Morgan Stanley entered into a joint venture that combined our existing Global Wealth Management business with Citigroup's Smith Barney unit, under Morgan Stanley's operational control. The combined entity—Morgan Stanley Smith Barney—is the leader in wealth management with nearly 18,000 high-quality financial advisors and $1.5 trillion in client assets.

Asset Management. Through portfolio managers located across the world, Morgan Stanley offers individual and institutional clients a diverse set of equity, fixed income, and alternative investments along with merchant banking strategies. These offerings permit clients a variety of investment styles, including value, growth, and fixed income; active and passive management; and diversified and concentrated portfolios. In October 2009, Morgan Stanley announced an agreement to sell its retail asset management business, including Van Kampen Investments, to Invesco. This agreement will allow Morgan Stanley to focus on its institutional client base, including corporations, pension plans, foundations, and endowments. At the end of 2009, the Asset Management business had $395 billion of assets under management or supervision.

B. Key Sources of Revenue and Profit

Morgan Stanley's Institutional Securities business has typically been the source of the majority of its revenues. For example, in the first nine months of 2009, Institutional Securities generated 56 percent of Morgan Stanley's net revenues. Global Wealth Management contributed 36 percent of net revenue during the same period and Asset Management contributed 8 percent. The relative contributions of these businesses to Morgan Stanley's overall net revenues has been roughly similar over the past several years. In 2008, Institutional Securities was responsible for 67 percent of net revenues, Global Wealth Management was responsible for 28 percent, and Asset Management was responsible for 5 percent. In 2007, Institutional Securities was responsible for 57 percent of net revenues, Global Wealth Management was responsible for 23 percent, and Asset Management was responsible for 20 percent.

As with the entire financial services industry, the past two and a half years have been extraordinarily challenging for Morgan Stanley as unprecedented market disruptions severely impacted some parts of our business. Despite those formidable challenges, Morgan Stanley ended 2008 with a strong balance sheet and an industry-leading Tier 1 capital ratio. The Firm generated solid revenues of $17 billion and net income of $400 million during the first nine months of 2009, although it remained a difficult year for Morgan Stanley and much of the financial services industry.

II. Morgan Stanley's Financial Challenges—and Actions Taken to Address Them

As the Commission knows, the entire financial services industry has been severely impacted by a series of macroeconomic shocks that began with a steep decline in United States real estate prices in 2007 that continued into 2008 and 2009. Morgan Stanley, like most of its peers, experienced significant losses beginning in late 2007, but acted early and aggressively to navigate the increasingly turbulent market environment.

While the Firm's residential mortgage related business was not as large as some of our peers, Morgan Stanley participated in the markets for residential mortgage-backed securities and collateralized debt obligations, and suffered losses as a result of its positions in these markets. Most significantly, during the fourth quarter of 2007, Morgan Stanley had to write down approximately $9.4 billion in losses related to its exposure to mortgage related securities and derivatives. Approximately $7.8 billion of these losses related to a proprietary trading position in one part of the Firm; the remainder related largely to our exposure to other mortgage-related products, which also had declined in value amidst the widespread decline in the credit and mortgage markets.

These early losses were a powerful wake-up call for Morgan Stanley, and we began moving aggressively in late 2007 and early 2008 to adapt our business to the rapidly changing environment—reducing leverage, trimming the balance sheet, raising private capital, and further strengthening risk management. For instance, Morgan Stanley brought its leverage down significantly—from 32.6 times at the end of 2007 to 11.4 times at the end of 2008. Similarly, we reduced our balance sheet from more than $1 trillion in 2007 to approximately $650 billion in 2008 as the Firm reduced its exposure to legacy assets. At the same time, we also further strengthened our capital and liquidity positions with a total of $24.7 billion in new Tier-1 capital. Due to these actions, Morgan Stanley was in a better position than many of our peers to weather the financial storm that occurred in late 2008.

Morgan Stanley delivered three consecutive quarters of solid financial results during the first nine months of 2008. Shortly thereafter, however, Lehman Brothers collapsed and the global financial markets plunged into an acute and severe crisis of confidence. In the immediate wake of Lehman's failure on September 15, Morgan Stanley and similar institutions experienced a classic "run on the bank," as investors lost confidence in financial institutions and the entire investment banking business model came under siege. In the days following Lehman's bankruptcy, Morgan Stanley and many other financial institutions experienced significantly wider credit spreads on their outstanding debt and sharp declines in stock market capitalization, which in turn led clearing banks to request that firms post additional collateral, causing further depletion of cash resources.

In an effort to stem the panic, we announced our very strong third quarter earnings a day earlier than planned—on September 16—but Morgan Stanley's stock price continued to drop. The crisis of confidence in the financial sector fed a chain reaction in the broader economy, as lower prices for financial assets undermined confidence and led to lower prices throughout the rest of the economy. This period was marked by rampant—often untrue—rumors and speculation, and the entire Morgan Stanley leadership team worked nonstop over the course of the following week to provide information to clients, the markets, and our employees in order to dispel the false rumors that were spreading through the financial markets and to provide investors with an informed basis to make investment decisions. We also worked closely with our regulators in an effort to keep them informed and achieve the right result for the markets, the economy and the Firm.

Ultimately Morgan Stanley's position began to stabilize on September 22, when the Firm announced that Mitsubishi UFJ Financial Group—the world's second largest bank holding company—agreed to enter into a global strategic alliance with the Firm as part of a $9 billion investment. This alliance, which closed in October 2008, was fundamental to Morgan Stanley's effort to arrest the panicked downward spiral that was affecting every major institution in the world financial markets in the fall of 2008.

In addition, on September 21, 2008, Morgan Stanley obtained approval from the Board of Governors of the Federal Reserve System to become a bank holding company upon the conversion of a wholly owned indirect subsidiary, Morgan Stanley Bank (Utah), from a Utah industrial bank to a national bank. The Office of the Comptroller of the Currency authorized this conversion and Morgan Stanley simultaneously became a financial holding company under the Bank Holding Company Act of 1956.

Morgan Stanley also accepted and pledged to responsibly use the government's investment through the TARP Capital Purchase Program. Morgan Stanley has, as you know, since paid back our TARP funds and repurchased the related warrants at a price that provided U.S. taxpayers a 20 percent annualized return on their investment. Our firm appreciates the importance of the federal government's financial support, which helped prevent a collapse of the financial system. There's no denying that every firm in the industry—and the broader financial markets as a whole—benefitted from this support.

III. Changes to Morgan Stanley's Policies and Practices Throughout the Crisis

As mentioned above, Morgan Stanley has taken a number of steps during and in the immediate wake of the crisis to strengthen our position and create a solid foundation for well managed growth, including reducing leverage, cutting the balance sheet, and raising capital. In addition to these stabilizing steps, Morgan Stanley also made several important, systemic changes to our business practices, risk management structures, and executive compensation policies, and we remain committed to continuing to improve these policies and practices in the months and years ahead.

A. Reducing Leverage and Related Risk

One of the clearest lessons from the 2008 crisis was that many firms simply carried too much leverage and took too much risk. Beginning in 2007, Morgan Stanley moved aggressively to reduce its leverage, bringing it down from 32.6 times at the end of 2007 to 15.7 times at the end of the third quarter of 2009. Today Morgan Stanley remains focused on maintaining prudent levels of leverage by carefully targeting capital to those businesses that offer the most attractive risk-adjusted returns.

B. Raising Capital

Morgan Stanley was among the first Wall Street firms to raise private capital in response to the crisis. In December 2007, Morgan Stanley entered into an agreement with China Investment Corporation Ltd. as a long-term financial investor to issue approximately $5.5 billion of new capital through equity units with mandatory conversion into company stock. This agreement helped to further bolster Morgan Stanley's strong capital position and ensured that we would have the resources necessary to pursue growth opportunities globally, while also building on our deep historic ties to and market leadership in China.

Morgan Stanley also maintained a sharp focus on our capital position throughout the 2008 financial crisis and up through the present. By the end of the third quarter of 2008, Morgan Stanley had a Tier-1 capital ratio of 12.7 percent, which was among the highest of its peers heading into the turmoil of the financial crisis. Then, in October 2008, Morgan Stanley entered into a global strategic alliance with Mitsubishi UFJ Financial Group, Inc. as part of its $9 billion investment in Morgan Stanley. As a result, Morgan Stanley achieved one of the highest Tier-1 capital ratios (approximately 15%), even before the $10 billion TARP loan from the U.S. Department of the Treasury.

C. Diversifying Revenue and Funding Sources

Morgan Stanley has also taken a number of steps to diversify our revenue and funding sources and create a more stable foundation for long-term growth. While Morgan Stanley remains close to our traditional investment banking and sales and trading roots, we have converted to a bank holding company, and have expanded our retail deposit base as part of a move to diversify our funding sources and further strengthen our risk management. As a financial holding company, Morgan Stanley is now subject to regulation by the Federal Reserve, including its risk-based and leverage capital requirements, and must maintain its capital at levels that are above the regulatory definition of well capitalized.

As part of the overall goal of generating revenue without putting significant amounts of capital at risk, Morgan Stanley has also focused on expanding our retail businesses. On May 31, 2009, Morgan Stanley closed on the Morgan Stanley Smith Barney joint venture with Citigroup, in which Morgan Stanley acquired 51% and majority representation on the Board of the newly-formed business. Morgan Stanley joined our retail brokerage forces with Citigroup's in order to create an industry-leading global wealth manager with long-term growth potential across the globe. This move further diversifies Morgan Stanley's overall business mix and gives us substantial scale and opportunity to realize revenue in a low capital intensive business. The integration of Smith Barney is currently on track and the first full-quarter results from the joint venture included stable revenues of $3 billion and a pretax profit of $280 million.

D. Further Strengthening Risk Management

Risk is an inherent part of Morgan Stanley's business and activities, as it is at all banks. Morgan Stanley's ability to properly and effectively identify, assess, monitor and manage each of the various types of risk involved in our activities is critical to the Firm's soundness and success. In the wake of the challenges described above, Morgan Stanley has devoted significant additional resources over the last two years to further strengthen our risk management policies and procedures.

The Firm's risk management-related governance structure includes the Firm Risk Committee, the Chief Risk Officer, the Internal Audit Department, independent control groups, and various other risk control managers, committees and groups in and across business segments. The Firm Risk Committee is composed of Morgan Stanley's most senior officers. It oversees the entire risk management structure and has responsibility for risk management principles, procedures and limits, and monitoring of material market, credit, liquidity and funding, legal, operational and franchise risks and the steps management has taken to monitor and manage such risks.

Morgan Stanley named a new Chief Risk Officer in early 2008 and changed the reporting line so that the Chief Risk Officer reports directly to the Chief Executive Officer. The Chief Risk Officer is a member of the Firm Risk Committee, and oversees compliance with Firm risk limits; approves certain excessions of Firm risk limits; reviews material market, credit and operational risks; and reviews results of risk management processes with the Audit Committee of the Board.

The Internal Audit Department provides independent risk and control assessment and reports to the Audit Committee. The Internal Audit Department examines Morgan Stanley's operational and control environment and conducts audits designed to cover all major risk categories.

In addition, each business segment has a risk committee that is responsible for ensuring that the business segment, as applicable, adheres to established limits for market, credit, operational and other risks; implements risk measurement, monitoring, and management policies and procedures that are consistent with the risk framework established by the Firm Risk Committee; and reviews, on a periodic basis, its aggregate risk exposures, risk exception experience, and the efficacy of its risk identification, measurement, monitoring and management policies and procedures, and related controls.

Each of Morgan Stanley's business segments also has designated operations officers, committees and groups, including operations and information technology groups, to manage and monitor specific risks and report to the business segment risk committee. The Firm also has

Market Risk, Credit Risk, Operational Risk, Financial Control, Treasury, and Legal and Compliance Departments. These departments are all independent of Morgan Stanley's business units and assist senior management and the Firm Risk Committee in monitoring and controlling Morgan Stanley's risk through a number of control processes.

The Firm has significantly strengthened staffing in the risk management function, adding approximately 100 new people over the past two years. In the trading business, Morgan Stanley created a new, additional risk monitoring function reporting to the head of Institutional Securities Sales and Trading, and made a series of changes throughout sales and trading that will create more discipline, partnership and transparency across the division. Morgan Stanley has also added increased market knowledge and trading expertise to complement its risk models and scenario analysis. Finally, Morgan Stanley's Board of Directors has recently established a new Risk Committee of the Board of Directors to further enhance its oversight of risk management throughout the Firm.

E. Improving Compensation Policies and Programs

Morgan Stanley's executive compensation program has historically contained a substantial equity component intended to align employees' interests with the long-term interests of its shareholders and other stakeholders. However, as a result of the unprecedented financial turmoil throughout the industry, we have made a number of changes to our compensation practices and structures to ensure that employee compensation is linked even more closely to performance and does not encourage unnecessary and excessive risk-taking that threatens firm value.

Morgan Stanley was the first major U.S. bank to enact a "clawback" for a portion of year-end compensation in 2008—one that exceeded TARP requirements. This provision could be triggered if an individual engages in conduct detrimental to the Firm, such as causing the need for a restatement of financial results, a significant financial loss, or other reputational harm to the Firm or one of its businesses. In 2009, the Firm strengthened the clawback language to be more specific and transparent regarding what actions or omissions taken by an employee or what kind of loss by the Firm would trigger a clawback. This clawback provision applies to a broad group of employees and will be in place for up to three years after the compensation is awarded.

Morgan Stanley also reduced overall year-end compensation significantly in 2008 in light of the Firm's performance and the challenging environment. Excluding Financial Advisor compensation (which is primarily commission-based), Morgan Stanley's 2008 bonus pool was reduced by approximately 50% from 2007, and the 2008 compensation of the senior Operating Committee executives was reduced by an average of 75% compared to 2007.

As CEO, I recommended to the Board that I not receive a bonus in 2007, 2008 or 2009—indeed, I never received a cash bonus during my time as CEO of Morgan Stanley. Any bonus I received was in equity and thus aligned my interests with shareholders' interests. In 2008, Morgan Stanley's two other most senior executives also did not receive bonuses.

Going forward, Morgan Stanley is tying "at risk" compensation even more closely to long-term performance. Morgan Stanley has had a requirement that Operating Committee members retain at least 75% of their equity awards while on the committee, which will continue. Morgan Stanley also enacted a new "multi-year" performance plan that pays senior executives in performance units that will make a portion of their year-end compensation directly contingent on Firm performance and total shareholder return relative to peers over the next three years. In addition, Morgan Stanley is increasing the portion of year-end compensation that is deferred for all employees—with the Operating Committee members in the aggregate receiving more than 75% percent of their year-end pay in deferred compensation. This change will further align compensation with the long-term success of the Firm. Morgan Stanley is also factoring risk-adjusted measures even more closely into compensation decisions for sales and trading teams, consistent with the recent Federal Reserve and G-20 guidelines.

Finally, Morgan Stanley has no contracts offering guaranteed incentive pay to senior executive officers, as defined by the Emergency Economic Stabilization Act of 2008. Morgan Stanley also has no severance guarantees for senior executive officers.

F. Lending Related Activities

Unlike some of the nation's other leading financial institutions, Morgan Stanley's business has historically been focused primarily on institutional and corporate clients, and not on retail lending to individual borrowers. As previously discussed, Morgan Stanley has helped its clients raise over $940 billion in debt and equity to invest in their businesses since the beginning of the fourth quarter of 2008. In addition, Morgan Stanley—through its residential loan servicing subsidiary Saxon Mortgage Services, Inc.—has been an active participant in the Administration's Home Affordable Mortgage Program ("HAMP"). According to the Servicer Performance Report released by the U.S. Treasury on November 10, 2009, Saxon leads all participating servicers in active trial modifications for eligible borrowers who are over 60 days delinquent. Saxon has been the number one servicer in this category since the U.S. Treasury began tracking the program in July 2009. In addition, Saxon has partnered with HOPE NOW—a nationally known borrower counseling group—in an effort to communicate with borrowers and help address their individual needs.

IV. The Role of Government in Stabilizing and Improving the Financial System

We at Morgan Stanley recognize how close the global financial system came to collapse during the fall of 2008 and the critical role that the federal government, and TARP in particular, played in restoring stability to the financial system. We and our employees appreciate the support provided to our industry by the U.S. government, Congress and the Administration during this challenging period, and we are proud of the fact that we were one of the first firms to repay the TARP funds that we received.

The financial crisis laid bare failures of risk management at individual firms across the industry and around the globe. But, more significantly from a policy perspective, it made clear that regulators simply didn't have the tools or the authority to protect the stability of the financial system as a whole. That's why we need a systemic risk regulator with the ability and responsibility to ensure that excessive risk-taking never again jeopardizes the entire financial system. We cannot and should not take risk out of the system—that's what drives the engine of our capitalist economy. But no firm should be considered "too big to fail." If a firm mismanages its risks, regulators need the authority to unwind it in a way that minimizes instability to the system.

It is also clear that the complexity of financial markets—and financial products—has exploded in recent years, but regulation and oversight have not kept pace. While many of these complex products were designed to spread out risk, they often had just the opposite effect—obscuring where that risk was concentrated and to what degree. Regulators and investors need to have a fuller and clearer picture of the risks posed by increasingly complex financial instruments and contracts, as well as the true value of those products. We should also aim to make more financial products fungible to ensure they can be transferred from one exchange or electronic trading system to another. To improve oversight and transparency, I believe that we need to establish a federally regulated clearing house for derivatives or require reporting to a central repository. This will help create a truly efficient, effective and competitive market in futures and derivatives, which would benefit investors and the industry as a whole.

Finally, today's financial markets are global and interconnected, and we believe our regulatory regime needs to be as well. Risk cannot be defined or contained by geographic borders. The U.S. must work with countries across the globe to coordinate and synchronize standards and enforcement. Otherwise, inconsistent regulation can result in "regulatory arbitrage" in which some market players seek competitive advantage by exploiting such differences, thereby distorting the competitive marketplace.

V. Conclusion

At Morgan Stanley, we believe the scrutiny facing the financial services industry ultimately can be a positive, if it leads to constructive changes in how firms operate, promotes greater discipline and transparency, and spurs sound regulatory reform. We are pleased to have had the opportunity to provide this information to the Commission. The important work of this Commission, as well as reviews now underway in other parts of the world, are critical to increasing understanding of the reforms that are needed, and I look forward to answering your questions as you proceed.