Morgan Stanley

By electronic submission

April 30, 2012

Re: Federal Reserve Notice of Proposed Rulemaking regarding Enhanced Prudential Standards for Covered Companies: Docket No. 1438, RIN 7100-AD-86

Ladies and Gentlemen:

Morgan Stanley appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's (the "**Federal Reserve**") notice of proposed rulemaking (the "**NPR**") implementing the enhanced prudential standards and early remediation requirements under Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). Morgan Stanley is deeply concerned with the proposed single-counterparty credit limit ("**SCCL**") rules' methodologies for calculating credit exposures and their application to certain entities. We believe the SCCL rules will grossly overstate exposures relative to realistic risks as determined by generally accepted risk measures and significantly constrain the capacity to extend credit between active participants in the financial markets.

We strongly support the comments on the NPR submitted by The Clearing House Association L.L.C., the American Bankers Association, The Financial Services Roundtable, and the Securities Industry and Financial Markets Association (together the "**Associations**"), including, and most importantly, with respect to the exposure calculations that result from using the current exposure method for derivatives and the "add-on" approach when a covered company is the securities seller or lender in securities financing transactions and repurchase agreements; the application of the notional shifting requirement when utilizing credit protection or acting as a market maker in credit protection contexts; and the reduction of the credit limit to 10% for major covered companies on their exposures to major counterparties. It is essential that the issues highlighted in the comment letter submitted by the Associations are resolved in a manner that avoids the severe impacts highlighted in that letter.

Morgan Stanley also supports the comments in the Associations' letter with respect to the "control" definition in the proposed SCCL rules but is submitting this letter separately to clarify how the proposed SCCL rules, applied to Morgan Stanley as a shareholder in a Japanese securities joint venture with Mitsubishi UFJ Financial Group ("**MUFG**"), will:

- substantially overstate Morgan Stanley's exposure, and thereby further constrain its ability to enter into credit transactions with counterparties whose obligations are also held by the joint venture; and
- double-count other covered companies' exposures to the joint venture by not only aggregating 100% of such exposures to their credit exposure to MUFG but also aggregating 100% of the same exposures to their credit exposure to Morgan Stanley. As

a result, other covered companies may be further constrained in their ability to enter into credit transactions with Morgan Stanley, MUFG or the joint venture.

The proposed SCCL rules are likely to reduce any covered company's capacity to enter into credit transactions with other counterparties. By mechanically applying a variant of the Bank Holding Company Act's control rules to joint venture entities in which a minority shareholder is treated as controlling the entity, the negative effects of the proposed SCCL rules are exacerbated, particularly if the joint venture is itself a major participant in the financial markets.

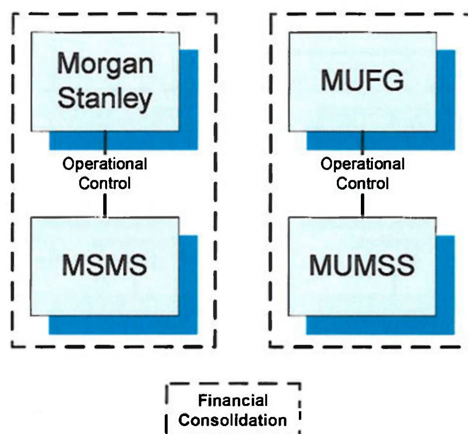
Each of these negative consequences can be illustrated by reference to Morgan Stanley's Japanese securities joint venture with MUFG, but they also have broad implications for other joint ventures and for the financial markets. For these reasons, as explained more fully below, Morgan Stanley specifically supports the Associations' recommendation to define "control" in the SCCL rules to include only companies that are consolidated for U.S. GAAP purposes.

The Japan Securities JV

In October 2008, at the height of the financial crisis, MUFG made a significant equity investment in Morgan Stanley, obtaining approval from the Board of Governors of the Federal Reserve System to acquire a combination of common equity and convertible preferred stock equivalent to up to 24.9% of Morgan Stanley's voting shares. MUFG and Morgan Stanley simultaneously announced the formation of a strategic alliance aimed at co-operation in a number of business areas. The lynchpin of this strategic alliance was the formation of a joint venture encompassing the two banking organizations' respective Japanese securities brokerage businesses (the "**Japan Securities JV**"), which were respectively renamed Mitsubishi UFJ Morgan Stanley Securities Co., Ltd. ("**MUMSS**") and Morgan Stanley MUFG Securities Co., Ltd. ("**MSMS**").

MUFG retained a 60% voting and economic interest in its Japanese securities brokerage subsidiary, MUMSS, while Morgan Stanley acquired a 40% voting and economic interest in that JV entity. Morgan Stanley for its part retained a 51% voting interest and 40% economic interest in its Japanese institutional securities brokerage subsidiary, MSMS, while MUFG acquired a 49% voting interest and 60% economic interest in MSMS. The accounting treatment of MUFG's and Morgan Stanley's respective interests in MUMSS and MSMS reflects the reality of the two banking organizations' ultimate ability to exercise effective managerial and operational control. MUMSS, over which MUFG exercises effective managerial and operational control, remains a consolidated subsidiary of MUFG. MSMS, over which Morgan Stanley exercises effective managerial and operational control, remains a consolidated subsidiary of Morgan Stanley. The Japan Securities JV structure is depicted in Diagram 1.

Diagram 1: Japan Securities JV Structure



This carefully considered and constructed structure could now result in unintended and negative consequences for Morgan Stanley and MUFG as a result of the application of the proposed SCCL rules.

The Proposed SCCL Rules

Under the proposed SCCL rules, a covered company such as Morgan Stanley must include in its calculation of "aggregate net credit exposure," "net credit exposure" and "gross credit exposure" to a counterparty the exposure of its "subsidiaries."[1] "Subsidiary" is defined as a company that "is directly or indirectly controlled" by the covered company.[2] The proposed SCCL rules in turn set out a three-prong test for "control," providing that a company "controls" another if it:

- owns, controls, or holds with power to vote 25% or more of a class of voting securities of the company;
- owns or controls 25% or more of the total equity of the company; or
- consolidates the company for financial reporting purposes.[3]

The Impact on Morgan Stanley's Credit Exposures as a Major Covered Company

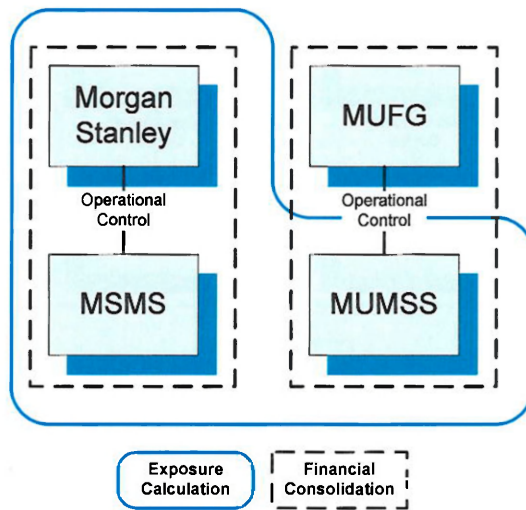
Because Morgan Stanley owns more than 25% of the voting and total equity of MUMSS, it would be required to include in its calculation of exposure to a counterparty the exposures of MUMSS. Morgan Stanley's credit exposure calculation as a Major Covered Company under the proposed SCCL rules is depicted in Diagram 2.

[1] Proposed Rule § 252.94(a).

[2] Proposed Rule § 252.92(jj).

[3] Proposed Rule § 252.92(i).

Diagram 2: Morgan Stanley's Credit Exposure Calculation as a Major Covered Company Under the Proposed SCCL Rules



Notwithstanding that Morgan Stanley does not consolidate MUMSS and that MUMSS's capital is not available to support Morgan Stanley's activities, Morgan Stanley would nevertheless be required to include all of MUMSS's credit exposures for purposes of complying with the single-counterparty credit limit. Similarly, other covered companies would be required to include their exposure to MUMSS in calculating their single-counterparty credit limits to Morgan Stanley and their exposure to MSMS in calculating their single-counterparty credit limits to MUFG.

MUMSS is a major Japanese securities broker-dealer. As such, it holds material positions in Japanese government bonds and Japanese government bond reverse repos. MUMSS may also have significant credit exposures to other Japanese financial institutions and other Japanese counterparties as calculated by the methodologies under the proposed SCCL rules. Aggregating the credit exposures of MUMSS with those of Morgan Stanley is problematic because it would substantially and inappropriately overstate Morgan Stanley's exposure to such Japanese issuers and counterparties – substantially, due to the shortcomings of the exposure calculation methodologies, as described in the Associations' letter; and inappropriately, because Morgan Stanley's maximum economic exposure to MUMSS consists of its 40% interest. The illogical attribution of MUMSS's exposures to Morgan Stanley would, in practice, significantly constrain Morgan Stanley's ability to enter into new credit transactions not only with the Japanese government but also with Japanese and non-Japanese financial institutions and other Japanese counterparties, and would very likely require the reduction of existing credit transactions with such counterparties.

In the worst case, Morgan Stanley may have zero credit exposures to MUMSS's counterparties but could be in violation of the SCCL limits due to the attribution of MUMSS's credit exposures to Morgan Stanley. In this worst case, this illogical breach of the SCCL limit would result in a regulatory violation for Morgan Stanley and a requirement to reduce MUMSS's credit exposures, even though Morgan Stanley has no operational or managerial control of

MUMSS. In short, Morgan Stanley's non-controlling, non-consolidated minority stake in MUMSS could unnecessarily curtail Morgan Stanley's and MUFG's roles as significant market-makers and liquidity providers in the Japanese financial markets, with the largest expected impact on their responsibilities as primary dealers in Japanese government bonds.

The following hypothetical example illustrates the problem described above. Suppose the "Covered Company" has assets of $750 billion, which include a $4 billion non-consolidating equity investment in a joint venture, and total capital of $50 billion. Under the proposed SCCL rules, the Covered Company's exposure to a single counterparty would be limited to 25% of total capital, or $12.5 billion. Suppose, further, that the joint venture has total assets of $150 billion, of which $15 billion is in the form of Japanese government obligations, and that the joint venture has total equity of $10 billion. It could be expected that a Japanese securities broker-dealer would have a large portion of its balance sheet—in this example, 10%—invested in or exposed to Japanese government obligations given the limited types of assets eligible for regulatory liquidity requirements (e.g., government obligations are typically deemed to be "liquid" assets but many other assets are not) and that large exposure limits in local jurisdictions might not be applicable to local sovereign obligations (e.g., U.S. government obligations are exempt in the proposed SCCL rules).

Here, the Covered Company would be required to include the joint venture's entire exposure to Japanese government obligations in determining its single-counterparty credit limits. As calculated under the proposed SCCL rules, the Covered Company's exposure to Japanese government obligations ($15 billion) would exceed 25% of the Covered Company's total capital ($12.5 billion), even if neither the Covered Company nor any of its consolidated subsidiaries had any exposures to Japanese government obligations.

This is an illogical and unwarranted result. In a joint venture arrangement such as the Japan Securities JV, each banking organization has strengthened the other banking organization's Japanese securities brokerage subsidiary through an infusion of capital and co-operative efforts designed to enhance each brokerage's ability to compete in the Japanese market. Joint ventures permit firms to allocate risk and control, including by granting majority ownership and managerial and operational control to a partner firm. These arrangements reduce, not increase, systemic risk by reducing firms' exposure to particular entities and therefore should not be penalized by the SCCL rules. In this case, Morgan Stanley's maximum economic exposure to MUMSS through the Japanese Securities JV consists of its 40% equity interest in MUMSS.

Yet by mechanically applying a variant of the Bank Holding Company Act's control test to what is supposed to be a quantitative prudential credit exposure limit, the proposed SCCL rules stands on its head the logic and economic advantage of a joint venture arrangement such as the Japan Securities JV. Far from recognizing that the joint venture arrangement enhances the competitiveness of Morgan Stanley's Japanese securities business while limiting its overall economic exposure, the proposed SCCL rules affirmatively penalize Morgan Stanley's participation in the Japan Securities JV. Instead of being treated realistically as a structure that diversifies Morgan Stanley's economic exposure and risk, the proposed SCCL rules artificially treat 100% of MUMSS's credit exposures as credit exposures of Morgan Stanley. Worse still, since Morgan Stanley does not have managerial or operational control over MUMSS, Morgan

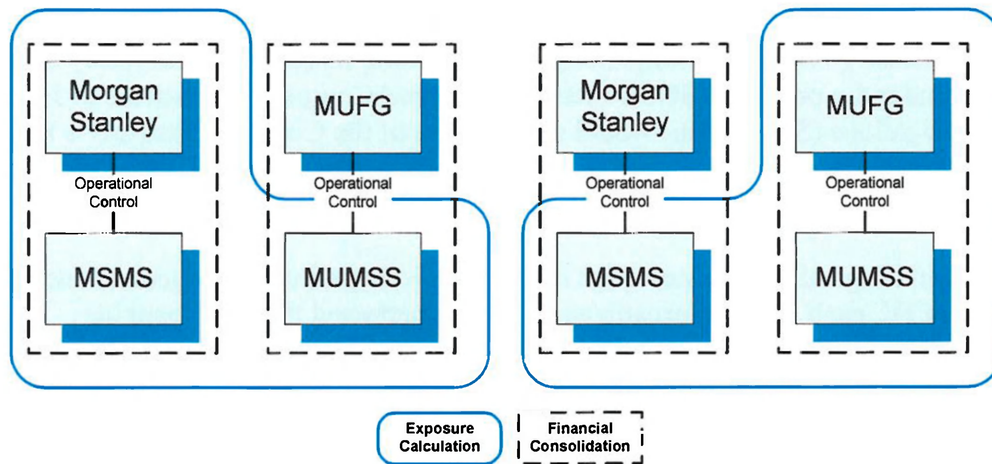
Stanley cannot manage MUMSS's credit exposures to ensure the Morgan Stanley consolidated group's compliance with the SCCL limits.

The Impact on Other Covered Companies' Credit Exposures to Morgan Stanley and MUFG

Equally problematic to Morgan Stanley is the fact that any other covered company subject to the proposed SCCL rules would now have to double-count its credit exposure to MUMSS—first, as part of the covered company's single-counterparty credit limit to MUFG (because MUMSS is a consolidated subsidiary of MUFG), and then again as part of its single-counterparty credit limit to Morgan Stanley (because MUMSS would be treated as "controlled" by Morgan Stanley). The same problem applies to MSMS. The double-counting resulting from the proposed SCCL rule is depicted in Diagram 3.

Diagram 3: Credit Exposure Calculations for Covered Companies that have entered into Credit Transactions with MSMS or MUMSS

Credit Exposures Attributed to Morgan Stanley | *Credit Exposures Attributed to MUFG*



For example, assume that a covered company enters into one credit transaction with MUMSS that generates a net credit exposure of $500 million and a separate credit transaction with Morgan Stanley that generates a net credit exposure of $500 million. Vis-à-vis MUFG, as the parent of MUMSS, the covered company would have a net credit exposure of $500 million for purposes of calculating its single-counterparty credit limit. But vis-à-vis Morgan Stanley, the covered company would now have to treat the same $500 million net credit exposure to MUMSS as a net credit exposure to a "subsidiary" of Morgan Stanley, resulting in an aggregate net credit exposure of $1 billion to Morgan Stanley.

This is also an illogical result. Two separate $500 million net credit exposures to two separate entities that are part of separate and distinct capital and consolidation structures—MUMSS, which is consolidated with MUFG, and Morgan Stanley—now become, vis-à-vis Morgan Stanley, treated as a single $1 billion credit exposure to a single consolidated group.

The proposed SCCL rules artificially create the appearance of $1 billion of risk when in reality Morgan Stanley's counterparty has only $500 billion of risk exposed to Morgan Stanley and the other $500 billion of risk is exposed to an entity controlled by and consolidated with MUFG. To the extent this may cause the covered company to reduce its aggregate net credit exposure to Morgan Stanley, perhaps by reducing the size of its $500 million Morgan Stanley credit transaction, this would negatively affect Morgan Stanley and impact our ability to effectively risk manage and competitively provide financial products and services to clients.

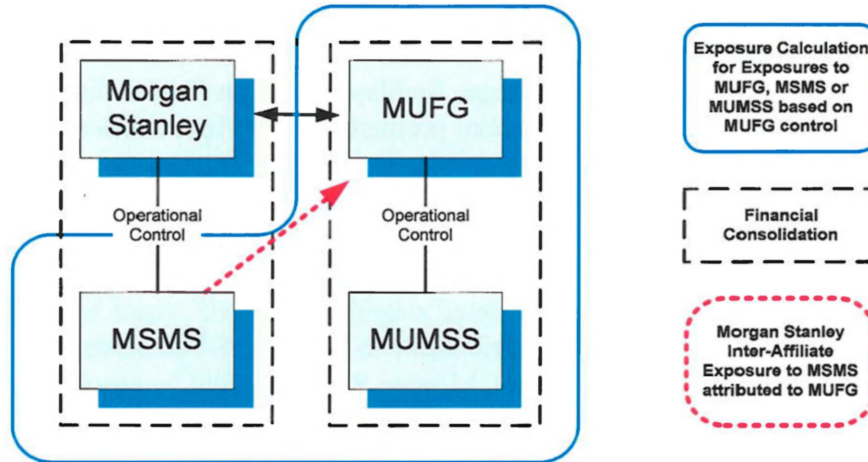
The Impact on Morgan Stanley of Treating MSMS as an MUFG Subsidiary

Even more illogical is the proposed SCCL rules' impact on Morgan Stanley's transactions with its majority-owned consolidated subsidiary, MSMS, since Morgan Stanley's credit exposures to MSMS would now be attributable to MUFG. When calculating its single counterparty credit exposure limits to MUFG, Morgan Stanley would be required to include its exposure to MSMS in its consolidated exposure to MUFG, even though Morgan Stanley, not MUFG, has effective managerial and operational control over MSMS.

As is only normal in dealing with a consolidated subsidiary, there are a number of intercompany transactions between Morgan Stanley and its other affiliates, on the one hand, and MSMS, on the other hand, for funding and risk management purposes. These consist primarily of secured and unsecured intercompany lending transactions and intercompany derivatives transactions. Assuming that none of MSMS's intercompany credit transactions are with Morgan Stanley's U.S. bank subsidiary, Morgan Stanley's intercompany credit transactions with its own consolidated subsidiary are not subject to any prudential counterparty limits.

Under the proposed SCCL rules, however, Morgan Stanley would have to treat any credit transaction with MSMS as being subject to its credit exposure limit to MUFG. This illogical outcome results from Morgan Stanley being required to treat its own consolidated subsidiary, MSMS, as a subsidiary of MUFG for purposes of the SCCL rules because MSMS would be treated as "controlled" by MUFG. This outcome is depicted in Diagram 4. The proposed SCCL rules could result in Morgan Stanley being constrained from providing appropriate credit and funding to one of its own subsidiaries. We believe this is inconsistent with how we should prudently risk manage one of our own subsidiaries.

Diagram 4: Morgan Stanley Credit Exposure Calculation
Under the Proposed SCCL Rules When Facing MUFG As A Counterparty



Finally, by attributing MSMS's exposures to MUFG, the proposed SCCL rules unnecessarily restrain Morgan Stanley's ability to enter into credit transactions with MUFG as a counterparty. As noted above, under the proposal SCCL rules, Morgan Stanley would be forced to include its credit exposure to MSMS in calculating its credit exposure to MUFG. This would unnecessarily impair Morgan Stanley's ability to enter into ordinary course credit transactions with MUFG and would not meaningfully reduce systemic risk.

Conclusion

In order to ensure more workable rules and avoid the unintended consequences described above, which would affirmatively discourage what are otherwise sensible efforts for covered companies to co-operate with other banking organizations and spread their economic risks in doing so, we strongly support the Associations' recommendation to define "control" as encompassing only companies that are consolidated for the covered company's U.S. GAAP financial reporting purposes.

Respectfully submitted,

Keishi Hotsuki
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