



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

February 5, 2009

Mr. Colm Kelleher
Chief Financial Officer
Morgan Stanley
1585 Broadway
New York, New York 10036

Dear Mr. Kelleher:

This letter is in response to the request from Morgan Stanley, New York, New York, for a temporary exemption from the application of certain aspects of the Board's market risk rule for bank holding companies (the "Market Risk Rule").¹

On September 21, 2008, the Board approved the application by Morgan Stanley to become a bank holding company.² To facilitate the orderly transition of Morgan Stanley to the Board's Market Risk Rule, Morgan Stanley has requested that it be permitted to use certain Value-at-Risk ("VaR") models approved by the SEC, as supplemented by supervisory add-ons approved by the SEC (together, "SEC-approved models"), to determine its capital requirements for specific risk under the Market Risk Rule through December 31, 2009.

Under the Market Risk Rule, an institution with significant exposure to market risk must maintain adequate capital to support that exposure.³ In

¹ 12 CFR part 225, Appendix E.

² Morgan Stanley, 94 Federal Reserve Bulletin C103 (2008). Morgan Stanley was previously subject to the capital requirements established by the U.S. Securities and Exchange Commission ("SEC"). See Appendix E to 17 CFR 240.15c3-1.

³ 12 CFR part 225, Appendix E, § 1(a). Positions covered by the Market Risk Rule ("covered positions") generally include all assets, liabilities, and off-balance-sheet items in an organization's trading account, and all foreign exchange and commodity positions both in and outside the trading account. Most covered positions are excluded from the

addition to the requirement for an institution subject to the Market Risk Rule to have a VaR model to measure general market risk, the institution also must capture its exposure to idiosyncratic or specific market risk either through a model approved by the Federal Reserve or by applying standard specific risk charges.⁴ The Board has authority to provide exemptions from the Market Risk Rule.⁵ The Board concludes that the limited and temporary relief described above would permit Morgan Stanley to complete the transition to the Market Risk Rule in a safe, sound, and orderly manner.

To allow an appropriate amount of time for Federal Reserve staff to conduct in-depth reviews of all relevant market risk models, the Board has decided that Morgan Stanley may use certain SEC-approved models to calculate its risk-based capital requirements for specific risk under the Market Risk Rule, provided that in no case shall Morgan Stanley use the SEC-approved models to calculate any capital requirements under the Market Risk Rule after the December 31, 2009, reporting date. Based on the Board's preliminary review, the risk-based capital requirements for specific risk produced by the SEC-approved models used by Morgan Stanley appear to be sufficiently conservative for the transition to the Board's Market Risk Rule. During 2009, Federal Reserve staff will, among other things, review the existing specific risk models of Morgan Stanley on a model-by-model basis. After Federal Reserve staff completes its review of each model, Morgan Stanley may continue to use that model to calculate the specific risk of covered positions under the Market Risk Rule only if Morgan Stanley has demonstrated to the Federal Reserve that the model adequately measures the specific risk of covered positions. If Morgan Stanley has not made such a demonstration, it must begin applying the standard specific risk capital requirements in the Market Risk Rule to all covered positions that are covered by the model immediately after Federal Reserve staff completes its review of the model.⁶

Board's general risk-based capital rules for bank holding companies ("Credit Risk Capital Rules"). 12 CFR part 225, Appendices A and F.

⁴ See 12 CFR part 225, Appendix E, § 5. If an institution has not demonstrated to the Federal Reserve that its model measures the specific risk of covered positions, it must use the standard specific risk capital requirements in the Market Risk Rule.

⁵ See 12 CFR part 225, Appendix E, § 1(b)(3).

⁶ See 12 CFR part 225, Appendix E, § 5.

During and after the transition period to full implementation of the Board's Market Risk Rule, Morgan Stanley must maintain the accounting controls surrounding its computation of capital requirements for market risk. These controls are a critical element supporting the reliability of reported capital requirements.⁷

This determination is specifically conditioned on compliance by Morgan Stanley with all the commitments and representations made to the Board in connection with the request for exemption. These commitments and representations are deemed to be conditions imposed in writing by the Board in connection with granting the request and, as such, may be enforced in proceedings under applicable law. This determination is based on the specific facts and circumstances of Morgan Stanley. Any material change in those facts or circumstances or any failure by Morgan Stanley to observe any of its commitments or representations may result in a different determination or in revocation of the exemption.

Please contact Homer C. Hill, III of the Federal Reserve Bank of New York at (212) 720-2164 if you have any questions.

Sincerely yours,



Robert deV. Frierson
Deputy Secretary of the Board

cc: Homer C. Hill, III
Federal Reserve Bank of New York

⁷ In addition, Morgan Stanley may not use internal models approved by the SEC to calculate its risk-based capital requirements for counterparty credit risk and instead must use the approach in the Credit Risk Capital Rules to calculate its capital requirements arising from counterparty credit risk. See 12 CFR part 225, Appendix A, § III.E. Furthermore, all the qualitative requirements in section 4(b) of the Market Risk Rule will apply immediately to Morgan Stanley's covered positions with capital requirements that are determined based on VaR models. See 12 CFR part 225, Appendix E, § 4(b).