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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

SOUTHERN DIVISION

JOEL STRATTE-McCLURE, STATE-BOSTON RETIREMENT SYSTEM and, FJÄRDE AP-FONDEN, Individually and on behalf of all others similarly situated, Plaintiffs, vs. MORGAN STANLEY, a Delaware corporation, JOHN J. MACK, ZOE CRUZ, DAVID SIDWELL, THOMAS COLM KELLEHER, THOMAS V. DAULA, and GARY G. LYNCH, Defendants.	Case No.: CV08-963 AG (FFMx) CLASS ACTION Honorable Andrew J. Guilford **AMENDED CLASS ACTION COMPLAINT**

Lead Plaintiff, State Boston Retirement System ("SBRS" or "Lead Plaintiff"), and named plaintiff, Fjärde AP-Fonden ("AP4"), individually and on behalf of all other persons and entities who purchased or otherwise acquired common stock issued by Morgan Stanley (hereinafter "Morgan" or the "Company") and traded on the New York Stock Exchange ("NYSE") from June 20, 2007 to December 19, 2007, inclusive (the "Class Period"), by their undersigned attorneys, for their Consolidated Securities Class Action Complaint (the "Complaint"), allege the following upon personal knowledge as to themselves and their own acts, and upon information and belief as to all other matters. Plaintiffs' information and belief is based on their investigation (made by and through their attorneys), which investigation included, among other things, a review and analysis of: (1) public documents pertaining to Morgan and the Individual Defendants, as defined herein; (2) Morgan's filings with the Securities and Exchange Commission ("SEC"); (3) press releases published by Morgan; (4) analyst reports concerning the Company; (5) pleadings in other litigations where Morgan is a party; (6) interviews with, *inter alia*, former Morgan employees; and (7) newspaper and magazine articles (and other media coverage including web logs or "blogs") regarding Morgan, its business or any Individual Defendant. Many of the facts supporting the allegations contained herein are known only to the Defendants or are exclusively within their custody and/or control. Plaintiffs believe that substantial further evidentiary support will exist for the allegations in this Complaint after a reasonable opportunity for discovery.

I. SUMMARY OF CLAIMS

1. On November 7, 2007, following rumors that had circulated the financial markets for a number of days, Morgan stunned its investors by confirming their worst fears. Contrary to what it had been telling the markets since the beginning of the Class Period-- namely, that the Company had little U.S. subprime exposure and to the extent that that it did, these exposures were fully hedged -- the Company revealed that it stood to lose billions of dollars from undisclosed aggressive trading bets that it had made on U.S. subprime securities. However, even at this point in time, the Company still continued to conceal critical information from the marketplace as it had yet to disclose that this problem stemmed from severe risk control deficiencies, that these losses should have been recognized in the Company's previous financial quarter, and that senior officers in the

Company knew about the failure to disclose (i) the Company's subprime exposure; (ii) the risk control deficiencies; and (iii) the losses resulting from Company's subprime exposure, as early as June 2007.

2. It was not until December 19, 2007 that the full extent of the losses sustained by the Company would be revealed. On that date, Morgan announced a staggering $9.4 billion loss on mortgage-related instruments for the quarter-ended November 30, 2007, $7.8 billion of which related to its previously undisclosed subprime-related positions. For the first time in its history, Morgan reported a quarterly loss, and of stunning proportions.

3. The Company's principal U.S. subprime exposure was the result of a risky trading strategy, embarked upon by a proprietary trading group (hereafter, the "Proprietary Trading Group"), which was established and empowered by Morgan's senior management to act as Morgan's internal hedge fund and to make riskier bets using the Company's capital than the Company had in the past, in order to generate higher returns.

4. The Proprietary Trading Group, established in April 2006 within the Company's Institutional Securities Group (sometimes, referred to herein as "ISG") grew out of a larger strategy employed by CEO John Mack to increase by multiples, risk taking by the ISG that was designed to improve Morgan's performance relative to its investment banking peers. Mack's perception was that his predecessor and nemesis, Robert Purcell had been too averse to risk and that, as a result, Morgan's reputation and profits had languished.

5. Deciding on a "radical shakeup" of Morgan, Mack placed Zoe Cruz in charge of his risk-taking strategy, as his Co-President and Head of the ISG. According to Mack, Cruz "shared his healthy appetite for risk taking." Cruz, reportedly, was a controversial selection and was not well received by many within the ISG, being seen as an opportunist rather than a sound trader.

6. Cruz and Mack, embracing a business plan that depended upon greater risk-taking in the ISG, ratcheted up the group's profits in 2005 and 2006, increasing the ISG's profits by 182% during this period, and securing record bonuses for themselves. In 2006, Mack earned $40 million in bonuses, a record on Wall Street at the time, while Cruz pocketed $30 million. Other traders within the ISG also took home record bonuses.

7. With this additional tolerance and directive for greater risk came the need for sound risk control policies. In light of this new strategy, investors frequently asked Mack and Morgan's senior executives what measures Morgan was taking to ensure sound risk management. In response to these questions, Mack and the other Defendants named herein repeatedly assured investors, both leading up to and during the Class Period, that the ISG's spectacular success under Zoe Cruz was the result of "effective, disciplined risk taking" and that Cruz and her team were able to "manage a tremendous amount of risk in a smart and disciplined way." At a shareholder meeting on April 21, 2007, Mack informed shareholders, in response to a question of Morgan's risk taking, "I am comfortable with the risk...I think we probably have one of the best overall risk managers in Tom Daula, who oversees all firm risk, and also Zoe growing up on the sales and trading side, mainly trading side risk management, it's a very strong combination. So I'm comfortable with it."

8. What Mack did not tell investors was that after his return to Morgan in 2005, as part of his radical shake-up of the Company, he had decided that Tom Daula, the Company's Chief Risk Officer, should no longer report to him, but rather to Zoe Cruz. This remarkable decision entrusted the ultimate supervision of risk control to the person whose department was assuming the risks! More significantly, this dramatic departure from established practice in the industry was not disclosed to investors. This undisclosed change in reporting structure would prove to be another fateful decision contributing to the massive losses investors in Morgan common stock suffered during the Class Period.

9. On June 20, 2007, the first day of the Class Period, Morgan reported stellar results for its Second Quarter 2007. These results were principally due to the spectacular returns reported by the ISG and, more specifically, an undisclosed subprime bet on a subprime-related security trade in the First Quarter of 2007 that worked out well for the Company. These results elated analysts and Morgan's investors because, for the rest of the U.S. investment banking industry, there were storm clouds on the horizon due to increasing troubles in the U.S. housing markets and subprime mortgages, and the fact that Morgan could turn in such good results without any negative exposure to subprime boded well for continued successful results.

10. For several months prior to that time, companies whose businesses involved or were

related to investments in U.S. subprime mortgages were facing unprecedented financial turmoil. Indeed, major subprime lenders had declared bankruptcy and investors that had invested in the complex instruments—including residential mortgage backed securities ("RMBS"), collateralized debt obligations ("CDOs") and credit default swaps ("CDS") – which were each dependent upon the success of U.S. subprime mortgages -- were facing huge losses. Indeed, within days of Morgan releasing its extremely positive second quarter 2007 results, Bear Stearns agreed to provide a $3.2 billion bailout to two separate multi-billion dollar hedge funds with significant subprime investments.

11. As a consequence of this turmoil in the industry, and because Morgan itself had acquired Saxon Capital, a major U.S. subprime originator in 2006, investors and analysts further inquired of the Company as to its subprime exposure. The response from Defendants was emphatic; there was nothing to worry about as Morgan had wisely taken a "net short" position on U.S. subprime and purportedly stood to profit from the decline in the U.S. subprime market. Morgan's financial disclosures were silent as to any subprime exposure on the Company's balance sheet.

12. Defendants' affirmative public statements, coupled with the absence of disclosures regarding the Company's positioning with respect to the U.S. subprime market, caused analysts, investors and ratings agencies to believe that the Company's subprime mortgage-related exposure was controlled and that Morgan was well-positioned, compared to its peers, to escape from the mortgage market meltdown relatively unscathed. For example, on March 21, 2007, Keefe, Bruyette & Woods analyst Lauren Smith raised her 2007 earnings estimate for the Company to $8.12 from $7.20. In doing so, Smith stated she believed the Company would "more than stand up to the perils we are witnessing in the sub prime mortgage market." Smith also pointed out that "[m]anagement noted they feel very confident in how they are positioned and their exposures to the sub prime mortgage markets." This was the total mix of information provided to the investing public leading up to the commencement of the Class Period.

13. Indeed, during the thick of the subprime crisis, on July 31, 2007, S&P actually upgraded Morgan from A+ to AA- and wrote, "While we recognize that recent capital markets

turmoil—precipitated by market issues in the subprime mortgage and leveraged corporate finance sector—could herald a period of much less favorable market conditions, we believe that structural improvements in Morgan's competitive position leave the firm especially well-positioned to withstand market volatility compared to industry peers."

14. In reality, however, the Company had enormous exposure to the turmoil in the U.S. subprime market by virtue of an undisclosed multi-billion dollar trade that the Proprietary Trading Group had made prior to the Class Period that was entirely dependent on the success or failure of subprime-related securities. This exposure, and its potential for massive losses for Morgan and its investors, would become well known to senior executives at the Company, including Zoe Cruz, by no later than May 2007.

15. The background of this multi-billion dollar trade begins in December 2006 when traders in the Proprietary Trading Group took on a series of trading positions in subprime mortgage derivatives which the Company secretly held on its balance sheet throughout the Class Period. The undisclosed strategy involved taking a net short position within the subprime mortgage market by purchasing CDSs -- essentially insurance policies triggered by the default of securities -- on lower-rated mortgage backed securities issued by CDOs.

16. In acquiring this short position through the acquisition of CDSs, Morgan had to make periodic premium payments to the CDS counterparty in exchange for this insurance protection. To offset the cost of the periodic premium payments due to the CDS counterparty, Morgan sold CDSs (*i.e*, sold insurance) on approximately $13.2 billion of so-called "super senior" tranches—the higher rated tranches--of so-called "mezzanine" CDOs, which entitled Morgan to receive periodic payments, which it used to finance the short position. The Defendants knew or recklessly disregarded that while the CDS positions that they had insured were highly rated by credit rating agencies, the majority of the underlying collateral consisted of BBB-rated mortgage backed securities linked to U.S. subprime mortgages.

17. In implementing this trading strategy, Morgan, through its Proprietary Trading Group, was effectively betting that mortgage defaults would be significant enough to impair the lower equity tranches of mortgage-backed securities, but not large enough to impair the value of super

senior tranches of the same or similar securities. If Morgan was correct in its strategy, the Company would profit from its short position while retaining the full value of its long position. If the defaults were higher than expected, however, the Company risked becoming vulnerable to the deteriorating mortgage market, as the gains realized on the short position would be completely wiped out by losses suffered on Morgan's $13.2 billion long position. As discussed in great detail below, the securities fraud alleged herein results not from this poorly executed trading strategy, but rather from the falsity of Defendants' statements throughout the Class Period regarding Morgan's exposure to the U.S. subprime market and its failure timely to write down positions and record losses from such exposure.

18. The fair value of the Proprietary Trading Group's $13.2 billion notional position, as Defendants would ultimately concede, was tied to the movement of an index called the ABX Index, which tracked the cost of insuring various tranches of residential mortgage backed securities. In particular, the fair value of the position was tied to the movement of the ABX Index for the BBB 06-1 vintage, the ABX index that tracked the cost of insuring BBB rated mortgage backed securities originated in the second half of 2005. These were the exact CDSs that Morgan had sold.

19. In the second quarter of 2007, mortgage defaults primarily affected the lowest tranches of the CDO structures and Morgan reported stellar results that were largely dependent upon its undisclosed positioning within the subprime market during this time. However, even then, there were significant warning signs within the market suggesting that the losses would eventually cut into the market value of the higher-rated BBB and AAA tranches and the Proprietary Trading Group's trade. As described below, this risk caught the attention of Zoe Cruz prior to the beginning of the Class Period.

20. According to an article published in May 2008 which appeared in *New York Magazine*, Zoe Cruz revealed that beginning in May of 2007, she became worried that the magnitude of the subprime mortgage fallout could negatively impact the value of the Proprietary Trading Group's position and other subprime related trades within the ISG. As a result, Cruz said that she began to require her department to unwind billions of dollars in subprime mortgage-related positions and informed her personal clients that they should avoid taking on mortgage-related

positions in light of the subprime market's impending collapse.

21. Cruz also stated in the interview that in May 2007 she ordered Defendant Thomas Daula, the Company's Chief Risk Officer, to run "stress tests" on the CDSs acquired by Proprietary Trading Group to calculate the amount of money the Company would lose based on various levels of deterioration within the subprime mortgage market. As mentioned above and described in greater detail herein, while the investing public was led to believe that Daula was reporting directly to Mack, in fact, he reported directly to Cruz.

22. On July 4, 2007, more than a month later and with the value of the CDSs continuing to decline, according to Cruz's account of events, Daula informed Cruz that the Company was potentially exposed to $3.5 billion in losses from the Proprietary Trading Group's CDS positions. According to the article, although Daula purportedly told Cruz that a loss of this magnitude was unlikely, Cruz claims to have told Daula, as well as Neal Shear, a well-known trader that ran Cruz's fixed income division, "I don't care what your view of probability is. Cut the position." According to Cruz, despite her orders, no action was taken and the $13.2 billion CDS position was not liquidated. In addition, the exposure resulting from the position remained undisclosed to investors and the public.

23. A dramatically different account is offered by Daula in an article published by the *Financial Times* in December 2007, which states that by August 2007, it was Daula himself who had warned senior executives at Morgan that there were "no proper pricing models for such trades, that positions were not being properly measured, and that the history traders used in their models was not a reliable guide."

24. Despite this acknowledged attention from Morgan's Co-President and Chief Risk Officer from May 2007 through August 2007 of the possibility of massive losses as a consequence of the Company's subprime exposures, the Defendants made several statements and/or omitted material information from other statements that was intended to and effective at keeping investors in the dark. In this respect, less than one week ***after*** Cruz says she unsuccessfully directed Daula and Shear to cut the Proprietary Trading Group's $13.2 billion CDS position, on July 10, 2007, the Company filed its second quarter 2007 quarterly report and it was absolutely devoid of any mention

of the Company's exposure to subprime losses.

25. Internally, however, there was extensive hand-wringing, finger pointing and intense pressure. During Morgan's third quarter of 2007, June 1, 2007 through August 31, 2007, the ABX Index that served as the underlying basis for the fair value of the Proprietary Trading Group's $13.2 billion CDS position, had fallen 32.8%. Such a drop should have required Morgan to take losses on the long position of at least $4.4 billion.

26. However, taking such an enormous loss was out of the question because it would have decimated the Company's credit ratings and caused Morgan to miss analysts' earnings estimates by a mile. In fact, on July 30, 2007, based on the Company's misrepresentations about its lack of exposure to subprime, as described above, Standard & Poor's actually upgraded the Company's debt ratings and raised its outlook from "stable" to "positive," meaning that no additional rating reviews were expected in the next two years.

27. Instead of acknowledging this drastic drop in fair value due to massive subprime exposure, the Defendants resorted to accounting chicanery. Rather than reflect the $4.4 billion loss that would be required by applying a fair value analysis based on the movements in the ABX Index as required by GAAP, the Defendants applied a more subjective valuation methodology to these assets in order to write down the position by only $1.9 billon, or by 14.4%, a far cry from the 32.8% write-down required by the decline in the ABX Index. The Company then reported earnings of $1.38 per share, which just barely met the lowest range of analysts' estimates for the quarter.

28. During Morgan's September 19, 2007 conference call announcing its earnings for the third quarter 2007, the Company did not disclose the $1.9 billion loss in ISG and failed to say anything about Morgan's massive subprime exposure. Later, in a chart accompanying its press release issued on November 7, 2007, Morgan would imply that, for purposes of its third quarter results, it had taken a fair value loss on its CDS position of $1.9 billion. However, no such disclosure was made in the third quarter 10-Q or earnings release, and, in any event, while disclosing the $1.9 billion loss in the ISG, omitted any suggestion that this loss was just the tip of a subprime iceberg that was melting quickly.

29. Even more remarkable about the Defendants' deafening silence about Morgan's

exposure to these subprime positions, and other exposures that it held on its balance sheet, was the fact that just three weeks earlier, Morgan had secretly received a letter from the SEC imploring the Company to be more transparent in its disclosures ***about its exposure to the U.S. subprime market.***

30. In this respect, the SEC, commenting on the Company's 2006 Form 10-K, filed with the SEC on February 13, 2007 and first quarter 10-Q, filed with the SEC on April 6, 2007, informed Morgan:

> It is unclear from your document the exposure you have to subprime loans. Based on your current public disclosures, it is possible that more clarity about your exposure to any subprime loans could be helpful. Regardless of the materiality of your exposures, we respectfully request that you provide us with supplemental information about your involvement in sub-prime loans.

31. No such additional disclosure was forthcoming in the Third Quarter 10-Q filed weeks after Morgan received the SEC's letter and, as investors would learn in the ensuing weeks, Morgan's exposure to subprime was not just material, it was massive.

32. This correspondence, and the series of exchanges between Morgan and the SEC that followed, were not available to the investing public until well into 2008, when the SEC had made the correspondence publicly available.

33. While Defendants were remaining silent on the losses the Company was suffering from the Proprietary Trading Group's position and the Company's huge exposure to subprime, the Company began to point fingers at members of the Proprietary Trading Group who had made the trades in the first place. In October 2007, seeing the writing on the wall, several members of the Proprietary Trading Group left the Company. Howie Hubler, the managing director of the Proprietary Trading Group, was quietly fired on November 2, 2007.

34. However, these developments were not lost on the analyst community. Within days of Hubler's firing, rumors began circulating in the analyst community about large losses at Morgan due to a massive subprime trade gone awry. On the morning of November 7, 2007, the *Wall Street Journal* published an article pointing to analysts reports published the day before which contended, based on "educated guesses" that Morgan would take a massive hit.

35. On the evening of November 7, 2007, Morgan changed its public stance. Stunning investors, Morgan announced that, contrary to its previous disclosures and assurances, the

Company did have extensive exposures to U.S. subprime securities and that, as of the end of the third quarter, it had approximately $10.4 billion in ***net*** exposure to subprime. The Company attributed much of this exposure to the trading position held by the Proprietary Trading Group, and admitted that losses in the amount of $3.7 billion due to movements in the ABX Index since the end of the third quarter (August 31, 2007) were being recorded by the Company.

36. This disclosure, while material in and of itself, only partially revealed the problems Morgan still faced. In this respect, Defendants already knew or recklessly disregarded that the belatedly-announced write-downs were entirely insufficient based upon the true movements in the ABX Index and, in fact, the Company would be forced to take larger write-downs in the fourth quarter.

37. When asked by one analyst from Merrill Lynch where these subprime positions could be found in Morgan's previous financial statements (*i.e.* earlier in the Class Period), Morgan's new CFO, Defendant Colm Kelleher, admitted that there had been no identifiable specific disclosure of the positions. Instead, unidentifiable portions of the positions were spread out "all over the place."

38. On November 29, 2007, Morgan Stanley fired Zoe Cruz along with other senior executives within the ISG.

39. The complete disclosure of Morgan Stanley's losses due to its trading in subprime securities would not be revealed until December 19, 2007. On that date, Morgan announced its earnings for the fourth quarter and fiscal year ended November 30, 2007. In that filing, Morgan announced that its total write-down of U.S. subprime and other mortgage related exposures was approximately $9.4 billion for Morgan's fourth quarter 2007, of which $7.8 billion primarily resulted from the trading activities first alluded to in Morgan's November 7, 2007 announcement. John Mack said on the earnings conference call on that day, "the results we announced today are embarrassing for me, for our firm, this loss was the result of an error in judgment that occurred on one desk, in our Fixed Income area, and also a failure to manage that risk appropriately. Make no mistake, we've held people accountable. We're moving aggressively to make the necessary changes."

40. The massive write-downs in the fourth quarter of 2007 were the result of known

deficiencies in the Company's risk controls, known failures in the Company's protocols for accounting for the Company's trading positions, and a concerted cover-up of these failures by Defendants' intentionally concealing the Company's losses and exposures when senior executives uncovered them during the Class Period. Once again, however, the securities claims are not based upon the failures themselves, but rather, Defendants' disclosures concerning the purported risk controls in place, the purported protocols in place for accounting for the trading positions of the Proprietary Trading Group, the fabrications issued by Defendants when confronted with questions by analysts and investors, and misrepresented financial statements that understated known losses about Morgan's subprime exposure.

41. As a consequence of the Defendants' knowing and reckless material misrepresentations and omissions in Morgan's financial reporting during the Class Period, the price of Morgan's common stock traded on the New York stock exchange was artificially inflated, and as the truth about Morgan's subprime exposures, the losses as a consequence thereof and the truth about the Company's lack of risk controls were revealed, Morgan's investors lost billions of dollars as this inflation was corrected. Plaintiffs, therefore, bring this action to recover their losses.

II. JURISDICTION AND VENUE

42. This action arises under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

43. This Court has subject-matter jurisdiction over this action pursuant to Section 27 of the Exchange Act, 15 U.S.C. § 78aa, and 28 U.S.C. § 1331.

44. Venue is proper in this District pursuant to Section 27 of the Exchange Act and 28 U.S.C. § 1391. Many of the acts and practices complained of herein, including the misrepresentations and schemes alleged herein, occurred in part in this District.

45. In connection with the acts, transactions and conduct alleged herein, Defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the United States' mail, interstate telephone communications and the facilities of a national securities exchange and market.

III. PARTIES

A. PLAINTIFFS

46. Lead Plaintiff State-Boston Retirement System ("SBRS") is an institutional investor that provides retirement benefits for the employees of the City of Boston, Massachusetts. It has more than 34,000 active and retired members, representing 106 mandatory retirement systems, and more than $3.1 billion in assets. SBRS purchased approximately 135,000 shares of Morgan Stanley stock at artificially-inflated prices during the Class Period, as set forth in the certification that was previously filed in this litigation and is incorporated herein by reference, and suffered losses in an amount to be determined at trial.

47. Plaintiff AP4, or the Fourth Swedish National Pension Fund, is based in Stockholm, Sweden and manages a portion of the pension assets of the citizens of Sweden. AP4 is part of the Swedish National Pension Fund ("AP Fund") system and was founded in 1974. With assets under management of approximately $32 billion and over four million members, AP4 is one of the largest institutional investors in Scandinavia and one of its most prominent pension funds. AP4 purchased 118,063 shares of Morgan Stanley stock at artificially-inflated prices during the Class Period, as set forth in the certification that is attached hereto as Schedule A, and suffered losses in an amount to be determined at trial.

48. State Boston Retirement System and AP4 are hereinafter referred to collectively as "Plaintiffs."

B. DEFENDANTS

1. Defendant Morgan Stanley

49. Defendant **Morgan Stanley** is a diversified financial services company incorporated in the state of Delaware and with its principal place of business and headquarters at 1585 Broadway, New York, New York. At all relevant times, Morgan's common stock traded on the New York Stock Exchange under ticker symbol "MS". Presently, the Company divides its operations into three primary business segments: Institutional Securities, Global Wealth Management and Asset Management. A fourth business group, Discover, which operated the Company's Discovery credit card operations was spun off during the Class Period, on June 30, 2007.

50. As described in more detail below, during the Class Period, approximately 60% of the Company's net revenue was derived from the ISG. The ISG engaged in 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.

51. During the Class Period, Defendant Morgan, through its officers and directors, published periodic filings with the SEC and made public statements which, as alleged herein, were materially false and misleading when made, and/or omitted to state material information which served to artificially inflate the price of the Company's common stock.

2. <u>Individual Defendants</u>

52. Defendant **John J. Mack** ("Mack") is the Company's Chairman and Chief Executive Officer ("CEO"). Defendant Mack became the Company's CEO and Chairman of the Company's Board of Directors in June of 2005 and has remained in both positions throughout the Class Period. During the Class Period, Defendant Mack participated in the issuance of, signed, and/or certified as accurate, the Company's SEC filings including, *inter alia,* the Company's Second and Third Quarter Form 10-Qs filed with the SEC on July 10, 2007 and October 10, 2007, respectively, which, as alleged herein, contained materially false and misleading statements when issued. In addition, Defendant Mack was a member of the Company's Management Committee throughout the Class Period, participated in earnings conference calls and made statements in the Company's press releases, which were also, as alleged herein, materially false and misleading when made.

53. Defendant **David Sidwell** ("Sidwell") served as the Company's Executive Vice President and Chief Financial Officer ("CFO") from March 2004 through October 11, 2007. Defendant Sidwell retired from his employment with Morgan on October 31, 2007. During the Class Period, Defendant Sidwell was a Member of the Company's Management Committee, and participated in the issuance of, signed, and/or certified as accurate, the Company's Second and

Third Quarter Form 10-Qs filed with the SEC on July 10, 2007 and October 10, 2007, respectively, which, as alleged herein, contained materially false and misleading statements when issued. In addition, throughout the Class Period, Defendant Sidwell made statements in the Company's press releases and earnings conference calls, which, as alleged herein, were materially false and misleading when made. Defendant Sidwell's conduct, statements and omissions caused the price of Morgan Stanley's common stock to be artificially inflated during the Class Period. For fiscal year 2007, Defendant Sidwell was awarded total compensation of $14.6 million in salary, bonus and other compensation.

54. Defendant **Thomas Colm Kelleher** ("Kelleher") is the Company's current Executive Vice President, Chief Financial Officer and the Co-Head of Strategic Planning, having assumed those positions on October 11, 2007 from Defendant Sidwell. Defendant Kelleher joined Morgan Stanley in December 2000 as the Head of Fixed Income Sales Europe becoming Co-head of that department in May of 2004. In February of 2006 Kelleher was promoted to Head of Global Capital Markets holding that position until October 11, 2007. During the Class Period, Defendant Kelleher was a Member of the Company's Management Committee. During the Class Period, Defendant Kelleher made statements in the Company's press releases and earnings conference calls, which, as alleged herein, were materially false and misleading when made. Defendant Kelleher also participated in conference calls with analysts held on September 19, 2007, November 7, 2007, and December 19, 2007. During these calls, Defendant Sidwell made numerous materially false and misleading statements that, as alleged herein, Defendant Kelleher did not contradict or qualify. Defendant Kelleher's conduct, statements and omissions caused the price of Morgan Stanley's common stock to be artificially inflated during the Class Period. For fiscal year 2007, Defendant Kelleher was awarded total compensation of $11.7 million in cash and incentives.

55. Defendant **Zoe Cruz** ("Cruz") was the Company's Co-President and the executive in charge of the ISG throughout most of the Class Period until she was fired on November 29, 2007. Defendant Cruz joined Morgan Stanley in 1982 and rose to the Head of its Fixed Income Division by September 2000, holding that position through March of 2005, when she was appointed Co-President of the Company upon Mack's return to Morgan. Cruz was also Director of Morgan

Stanley from March of 2005 through June of 2005, and was Acting President from July 2005 through February of 2006. Defendant Cruz, a control person of the Company, was a Member of the Company's Management Committee, and participated in the issuance of the Company's Second and Third Quarter Form 10-Qs filed with the SEC on July 10, 2007 and October 10, 2007, respectively, which, as alleged herein, were materially false and misleading when issued. In addition, Defendant Cruz participated in and/ or prepared information concerning the Company's financial performance and operations which was set forth in financial reports which, as alleged herein, were materially false and misleading when issued. Defendant Cruz's conduct, statements and omissions caused the price of Morgan Stanley's common stock to be artificially inflated during the Class Period.

56. Defendant **Thomas V. Daula** ("Daula") was the Company's Chief Risk Officer ("CRO") throughout the Class Period and remained so until announcing his retirement from Morgan on February 22, 2008. Prior to being named Chief Risk Officer in April of 2005, Daula had been the Company's Head of Market Risk. As Chief Risk Officer, Daula was responsible for developing and implementing Morgan Stanley's risk controls and the disclosures concerning these controls in Morgan Stanley's financial statements issued to the investing public during the Class Period. Defendant Daula, a control person of the Company, was a Member of the Company's Management Committee throughout the Class Period, and participated in the issuance of the Company's Second and Third Quarter Form 10-Qs filed with the SEC on July 10, 2007 and October 10, 2007, respectively, which, as alleged herein, were materially false and misleading when issued. Defendant Daula's conduct, statements and omissions caused the price of Morgan Stanley's common stock to be artificially inflated during the Class Period.

57. Defendant **Gary G. Lynch** has served as the Company's Chief Legal Officer of Morgan Stanley since October 18, 2005, General Counsel and a member of the Company's Management Committee. Defendant Lynch reported directly to Defendant Mack and was responsible for the Company's regulatory filings with the SEC and for managing litigation matters instituted by and against the Company. Defendant Lynch sat on the Company's Management Committee with Defendant Daula. During the Class Period, Defendant Lynch, a control person of

the Company, and participated in the issuance of the Company's Second and Third Quarter Form 10-Qs filed with the SEC on July 10, 2007 and October 10, 2007, respectively, which, as alleged herein, were materially false and misleading when issued. Defendant Lynch's conduct, statements and omissions caused the price of Morgan's common stock to be artificially inflated during the Class Period. During fiscal year 2007, Defendant Lynch earned total compensation of over $11.87 million.

58. Hereinafter, Defendants Mack, Sidwell, Kelleher, Cruz, Lynch and Daula will be collectively referred to as the "Individual Defendants."

IV. CONTROL PERSON ALLEGATIONS/GROUP PLEADING

59. By virtue of the Individual Defendants' positions of management and control within the Company, they had access to undisclosed adverse information about Morgan, its business, operations, operational trends, finances, and present and future business prospects. The Individual Defendants would ascertain such information through Morgan's internal corporate documents, conversations and connections with each other and corporate officers, employees, attendance at sales, management, and Board of Directors' meetings, including committees thereof, Management Committee Meetings, and through reports and other information provided to them in connection with their roles and duties as Morgan officers and/or directors.

60. It is appropriate to treat the Individual Defendants collectively as a group for pleading purposes and to presume that the materially false, misleading and incomplete information conveyed in the Company's public filings, press releases and public statements, as alleged herein was the result of the collective actions of the Individual Defendants identified above. The Individual Defendants, by virtue of their high-level positions within the Company, directly participated in the management of the Company, were directly involved in the day-to-day operations of the Company at the highest levels and were privy to confidential proprietary information concerning the Company, its business, operations, prospects, growth, finances, and financial condition, as alleged herein.

61. The Individual Defendants were involved in drafting, producing, reviewing, approving and/or disseminating the materially false and misleading statements and information alleged herein, were aware of or recklessly disregarded the fact that materially false and misleading

statements were being issued regarding the Company, and approved or ratified these statements, in violation of securities laws.

62. As officers, directors and controlling persons of a publicly-held company whose common stock is registered with the SEC pursuant to the Exchange Act, and is traded on the NYSE, and governed by the provisions of the federal securities laws, the Individual Defendants each had a duty to promptly disseminate accurate and truthful information with respect to the Company's financial condition and performance, growth, operations, financial statements, business, markets, management, earnings and present and future business prospects, and to correct any previously issued statements that had become materially misleading or untrue, so that the market price of the Company's publicly-traded securities would be based upon truthful and accurate information. The Individual Defendants' material misrepresentations and omissions during the Class Period violated these specific requirements and obligations.

63. The Individual Defendants, by virtue of their positions of control and authority as officers and/or directors of the Company, were able to and did control the day-to-day trading and attendant risks of the Company's largest business segment, ISG, and the content of the various SEC filings, press releases and other public statements pertaining to the Company during the Class Period. The Individual Defendants were provided with copies of the documents alleged herein to be misleading prior to or shortly after their issuance and/or had the ability and/or opportunity to prevent their issuance or cause them to be corrected. Accordingly, they are responsible for the accuracy of the public reports and releases detailed herein.

64. Each of the Defendants is liable as a participant in a scheme, plan and course of conduct that operated as a fraud and deceit on Class Period purchasers of the Company's common stock. Throughout the Class Period, Defendants disseminated materially false and misleading statements and suppressed material adverse facts about Morgan's exposure to subprime securities, and the quality of Morgan's risk and internal controls. Among other fraudulent conduct, the Defendants concealed losses suffered by Morgan as a consequence of its exposure to subprime securities and thereby artificially inflated the price of Company's common stock.

V. CONFIDENTIAL WITNESSES

65. Confidential Witness #1 ("CW 1")[1] was an associate at Morgan in the Fixed Income division's mortgage pass-through trading desk from July 5, 2005 until August 15, 2007. Generally, CW 1 provided information regarding, *inter alia*, the Proprietary Trading Group.

66. Confidential Witness #2 ("CW 2") worked as a junior employee within Morgan's Fixed Income Group from late 2005 until February 2008. CW 2 provided information regarding, *inter alia,* the Proprietary Trading Group run by Howard Hubler and the general organizational structure of the Fixed Income Group.

67. Confidential Witness #3 ("CW 3") worked in the securitized products group at Morgan from July 2006 until April 2008. Specifically, CW 3 worked in a variety of positions as an analyst, dealing primarily with mortgage-backed securities. CW 3 provided information regarding, *inter alia*, the Proprietary Trading Group and the factors used by Morgan Stanley traders to value their positions.

68. Confidential Witness #4 ("CW 4") was a senior level, long-term, employee in Morgan's fixed income division during the Class Period. During his/her tenure at Morgan, CW 4 had direct contact with Defendant Cruz. Prior to leaving Morgan in 2008, CW 4's responsibilities included assessing risk exposures in connection with a variety of financial instruments.

69. Confidential Witness #5 ("CW 5") held a variety of positions within Morgan between 2002 and January of 2008. Most recently, CW 5 was employed as a Management Reporting CFO in the equity division, where s/he oversaw two proprietary trading groups. CW 5 provided information regarding, *inter alia*, the general organizational structure of Morgan's Institutional Securities Group, the manner in which proprietary trading groups operated within Morgan, its risk management and valuation review policies, and the circumstances giving rise to

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[1] In an effort to protect the identities of knowledgeable witnesses who have come forward on a confidential basis, Plaintiffs have not pleaded all available information concerning job titles, locations, and starting and ending dates of employment when providing such information would be tantamount to revealing the witness' identity. Plaintiffs will provide such information to the Court *in camera* if the Court so requests.

the Company's 2007 losses.

VI. SUBSTANTIVE FACTUAL ALLEGATIONS

70. This case is brought on behalf of investors in Morgan's common stock who relied on the Defendants' misrepresentations and omissions in Morgan's public statements and SEC filings concerning the Company's risk of loss associated with the collapse of securities linked to U.S. subprime mortgages. During the Class Period, Morgan secretly placed an extraordinary bet on movements in the subprime market, and as a consequence, took on a massive risk, to the tune of $13.2 billion, that if this position failed and the subprime market moved in a manner that was not contemplated by the traders who assumed this position, the Company and its investors would suffer an unprecedented loss.

71. As set forth in detail below, Morgan's massive bet on subprime was in furtherance of a business strategy put in place by Morgan's CEO, John Mack, to expand Morgan's risk taking so as to better compete with Morgan's rival investment banks. Critical to this strategy, as the Defendants repeatedly assured investors, were sound risk control policies and effective internal controls. As set forth below, despite the Company's specific and direct assertions to the contrary, Morgan's risk management policies and structure were unsound and its internal controls ineffective and, together with the fraudulent conduct of the Defendants, directly contributed to the Company artificially inflating its financial results during the Class Period.

72. As a consequence of these ineffective risk management policies and poor internal controls, and despite a massive subprime exposure held on Morgan's balance sheet, Morgan told investors prior to and during the Class Period that it had little, if any, exposure to the downturn in the U.S. subprime mortgage markets. These statements had the effect of artificially inflating Morgan's share price and securing favorable credit ratings by rating agencies. In fact, however, Morgan had billions of dollars in exposure to U.S. subprime securities, and the most significant of these exposures was the single trading bet on subprime securities made by one of Morgan's most prominent group of proprietary traders.

73. At the start of the Class Period, when Morgan's senior executives realized that the Company stood to lose billions because of this single trading bet, they schemed to conceal this

exposure through misleading disclosures and omissions and engaged in accounting chicanery to avoid recognizing losses as required by GAAP. They also concealed the Company's other exposures to U.S. subprime securities. Defendants hoped that the subprime market would turn around so that Morgan could avoid having to report any losses relating to U.S. subprime securities, prior to having to disclose these exposures. Instead, the U.S. subprime market worsened and for the quarter-ended November 30, 2007, the Company was forced to take a $9.4 billion write-down on its subprime exposures and report a $3.9 billion net loss, the largest in its history by far.

A. <u>The Return of John Mack to Morgan Stanley</u>

74. Morgan's foray into the high-risk U.S. subprime mortgage market began after Defendant Mack returned as the CEO of the Company in 2005 with the stated goal of increasing the Company's risk taking.

75. Defendant Mack joined Morgan as a bond trader in 1972, and had become President of the firm in 1997 when it merged with Dean, Witter, Discover & Co. ("Dean Witter"). Dean Witter CEO Philip Purcell headed up the merged company, known as Morgan Stanley Dean Witter. Known as a risk-averse CEO, Purcell's reluctance to trade in sophisticated financial instruments like rival investment banks caused a rift to form between the Dean Witter camp and the Morgan Stanley camp, led by Defendant Mack.

76. After a bitter dispute between the two sides, Purcell succeeded in ousting Mack in 2001. Upon leaving Morgan, Mack became the CEO of Credit Suisse First Boston and, later, Co-CEO of Credit Suisse Group.

77. At Morgan, Purcell remained unwilling to put the firm's capital at risk. Instead, his business model generated most of its revenues from fee-based services such as mergers and acquisitions. Purcell's vision for the Company brought many detractors within and outside the Company to the point where, on March 3, 2005, eight former senior executives of Morgan, self described as the "Group of Eight," who believed Purcell's vision for the Company was compromising their retained ownership interests in the Company, began a very visible public battle to unseat Purcell as CEO. The Group's efforts included, among other things, publishing a full page advertisement in the Wall Street Journal criticizing Purcell's performance.

78. Internally, senior executives, including the Chief Operating Officer and head of the Institutional Securities Group, Vikram Pandit, had aligned themselves with the Group of Eight, and also sought Purcell's ouster.

79. Defendant Zoe Cruz, a twenty-four year veteran of Morgan, who was the head of Morgan's Fixed Income Group at the time, a division within ISG, cast her lot with Purcell. Cruz had joined Morgan in 1982 and had established a "reputation as a tough and savvy trader with quick and unwavering views on market positions." This reputation was described in a May 5, 2008 article in *New York Magazine* titled "Only the Men Survive, The Crash of Zoe Cruz." Under the tutelage and protection of John Mack, Cruz had risen to the head of Morgan's fixed income trading business, but when Mack was ousted in 2001, she declined to accompany him to Credit Suisse, citing her loyalty to Morgan.

80. Under Purcell, however, Cruz skirmished with Pandit, her immediate superior and the head of Institutional Securities Group, and when Pandit and several other senior executives mounted an insurrection against Purcell, she refused to join them, deciding to align her fate with that of Purcell.

81. In March 2005, facing internal dissent and outside criticism, Purcell honed his ranks and elevated a number of people he perceived to be loyal to him, while seeking to marginalize others. Among those he promoted was Zoe Cruz, who Purcell appointed Co-President of the Company on March 28, 2005 along with another long-time Morgan executive, Stephen Crawford. Crawford and Cruz were also appointed to the Company's board of directors a few weeks later. Another beneficiary of the management shuffle in March 2005 was Defendant Daula, who was elevated to Chief Risk Officer of the Company from head of Market Risk, and thereby began reporting directly to Purcell.

82. The promotion of Cruz to a position senior to her former boss Pandit led to the exodus of several high-level executives in the company's investment bank division led by Pandit. These included Brian Leach, who advised Pandit on strategy and risk, John Havens, head of equities, Guru Ramaskrishnan, head of equity trading, and Vikram Gandhi, a co-head of financial institutions banking. In April 2005, the head of Morgan's investment bank, Joe Perella, also

announced his departure.

83. Given this hemorrhaging of senior executives and the outside pressure from the so-called "Group of Eight," on June 13, 2005, Purcell was pushed out of the Company. Reportedly, in agreeing to resign, Purcell attempted to influence the selection of the next CEO of the Company and requested that none of the Group of Eight be considered for the position. He also negotiated a severance package for Stephen Crawford worth $32 million.

84. Cruz, however, declined to leave, and instead elected to stay on and see who the successor of the Company would be. According to an interview with Cruz in *New York Magazine*, she pushed the Board of Directors—reportedly through influence she had as one of the few female power-brokers on Wall Street—to rehire John Mack. While the Group of Eight was opposed to Mack being hired, the Board was concerned that rehiring any of the recently departed executives, like Pandit, would interfere with Cruz's leadership position. On June 30, 2005, Morgan named John Mack as the new CEO.

85. As *New York Magazine* reported on May 5, 2008, of John Mack's return to Morgan and Cruz's fate:

> With Mack back, Cruz hoped that she might not simply survive but thrive. "Zoe was lobbying hard to be appointed the sole president," says a former insider, rather than continue with the title of acting president.
>
> As he explored what to do, Mack was barraged by Cruz's critics, who suggested that she had "developmental issues" as a manager, says a senior executive at Morgan Stanley. She could be imperious, they claimed, refusing to consider other opinions. To allay concerns, he brought in a management coach to help smooth out some of Cruz's rough edges. (Cruz's supporters say the coach was her idea, to help her team communicate better.) He also began meeting with Pandit and the other ousted executives to discuss bringing them back into the fold. They told him they would come, but only if Cruz were gone.
>
> Mack refused the ultimatum. "John kept her on when everyone knew the ranks would have all come back," says a person close to Pandit. "They couldn't believe she'd done what she'd done. John must have had his reasons." Cruz was kept on as co-president, with a new co-president, Robert Scully, to manage alongside her.

86. With these deep schisms within the Institutional Securities Group, Mack retained Cruz in the position of Co-President of the Company, and appointed her head of the Institutional

Securities Group. She was, however, removed from the Board of Directors. Mack, reportedly, believed that Cruz "shared his healthy appetite for risk."

87. While Cruz stood at the helm of the Institutional Securities Group, her lieutenants were Neal Shear and Jerker Johansson who served as the Co-Heads of the Sales and Trading arm of the ISG—the front office of ISG's trading operations.

88. Neal Shear, a "celebrity trader" at Morgan, was the head of Fixed Income, within the Sales and Trading division. In 2006, Neal Shear was the second highest compensated person in the Company.

B. Mack Implements an Aggressive Risk Focused Business Plan

89. In the fall of 2005, Mack set out to revitalize Morgan's business plan. In Mack's eyes, Purcell's aversion to risk had caused the Company to miss out on significant growth opportunities. As recounted in an article by *Business Week* on June 21, 2006: "In a speech to shareholders shortly after his arrival at the Company, Mack explained that the Company's main problem wasn't its strategy or its business mix, as was widely believed, but its culture. It had become soft and timid, missing out on growth opportunities in everything from private equity to mortgages, junk bonds to equity derivatives." As a consequence, Mack, according to the article, was "embarking on a radical shakeup of Morgan Stanley."

90. In November 2005, Mack boldly announced to analysts and investors a five-year plan to double the Company's 2005 pre-tax profits. Key in this business plan was aggressive growth in the Institutional Securities Group, which was to be led by Defendant Cruz. *Fortune Magazine*, in a March 15, 2006 titled "Is Mack on the Right Track?" described how the ISG was perceived, among other Morgan's divisions, to be the reason why the Company was performing below its peers:

> Finally, there's Morgan's institutional securities arm. There are two sides to this business: the agency model and the principal model. Investment banking, mergers and acquisitions, and securities underwriting are the agency side (or acting as an agent). It is a huge global franchise for Morgan Stanley that's in no danger of expiring, but gradually this old school is becoming less profitable on Wall Street. UBS analyst Glenn Schorr writes of Morgan Stanley, "It's the institutional securities segment that has been one of the main driving forces behind the company's subpar ROE."

> There is now a push at Morgan to expand the principal business (or acting as a principal in a transaction). The risks here are obvious: Do it right, you become Goldman; do it wrong, and you're in deep yogurt.
>
> Controversial co-president Zoe Cruz ("There's nothing subtle about her," says one insider) and others like rising star Neal Shear, co-head of institutional sales and trading, are putting more of the firm's capital to work and ratcheting up its risk-reward profile. "The greater risk is not doing it," is how Mack puts it.

91. In their quest for outsized returns, Cruz and Mack steered the Company into taking increased trading risks. As reported in a *Forbes Magazine* article titled "Upping the Ante," dated March 27, 2006, Morgan's business plan for growth in its Institutional Securities Group rested on an expansive approach to risk taking, and it was paying dividends:

> Morgan Stanley was just the latest investment bank to trounce analyst expectations last week, with fiscal first-quarter earnings well above estimates in part because of a huge boost from trading for its clients and for the house account.
>
> It's making life hell for analysts who obsess over these numbers and what they mean for big banks' bottom lines.
>
> Wall Street can expect more risk-taking in trading this year. Take Morgan Stanley as an example. So-called value-at-risk in the fiscal first quarter was higher than average, said Chief Financial Officer David Sidwell during a conference call. This is a strategic goal. "Over time you'd expect us to be taking more risk, not just in commodities but across the other aspects of our fixed-income and equities business, consistent with the strategy," he said.
>
> Zoe Cruz, Morgan Stanley's co-president, affirmed this view in comments to European investors, saying, "We must take more risk than we have been taking in the past."
>
> * * *
>
> Morgan's more aggressive stance on trading risk might have something to do with the world views of its top managers. John Mack, who joined as chief executive in June, is an ex-trader, as is Cruz. Both came up through the rough and tumble world of fixed-income. "Not taking enough risk is the biggest risk of all," says Cruz. A spokesman for Morgan Stanley also declined to comment but pointed to Cruz's comment: "The corner stone of our risk management strategy has always been that we are not going to take risk that will endanger the franchise ... but I feel there was a lot of room and there is still a lot of room to take more market risk."

92. Expanding on this business plan, in April 2006, Morgan created the Proprietary Trading Group in an attempt to improve its reported income rating among the Company's investment banking competitors. The Company moved five traders from the its securitized products group to this new Proprietary Trading Group. Housed in the ISG, the Company structured the new group to operate like a hedge fund under the supervision of managing director Howard

Hubler. Hubler reported directly to Anthony Tufariello, the global head of securitized products. As head of fixed income, Neal Shear held supervisory responsibility over the activities of Hubler's group.

93. According to an April 17, 2006 *Financial News* article, the Proprietary Trading Group invested Morgan's own assets and focused primarily on trading opportunities in structured products and secured asset classes in both cash and derivative markets, including mortgage-related assets. While the Proprietary Trading Group operated within the ISG and was located on the 10th floor of the Company's Manhattan headquarters, the desk's positions and strategies were kept isolated from Morgan's other trading desks. According to CW 2, Morgan's internal regulations required that a "Chinese Wall" be erected between the Proprietary Trading Group and other fixed income traders in order to "keep the [proprietary] strategies and information separate."

94. However, given the high importance of this trading group to the Institutional Securities Group's bottom line, senior executives, including Tom Daula, Zoe Cruz and Neal Shear, all kept close tabs on the Proprietary Trading Group's performance.

C. **The Institutional Securities Group Reports Record Results as a Result of the Additional Risk Taking**

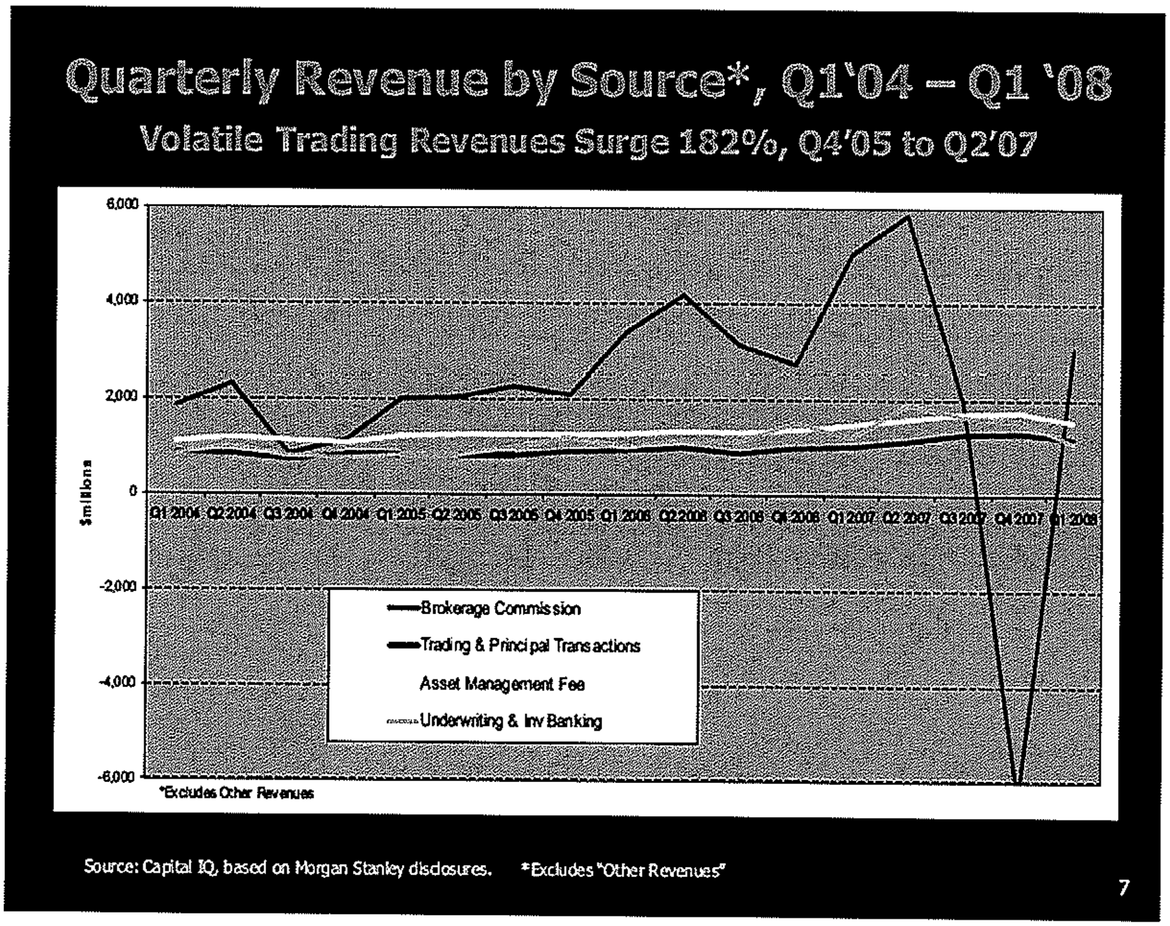
95. Mack's focus on taking on more risk in ISG appeared to investors as paying dividends. Throughout 2006, and through the first two quarters of 2007, ISG reported record results:

- For the second quarter of 2006, ended May 31, 2006, Morgan reported, "Institutional Securities achieved record net revenues of $5.7 billion, up 71 percent from the same period last year, and record income before taxes of $2.3 billion, up 179 percent." These revenues accounted for 64% of Morgan's $8.9 billion of total revenue. As reported by the Company, "Fixed income delivered sales and trading revenues were $2.4 billion, up 95 percent increase from the same period last year and the second highest ever."
- For the third quarter of 2006, ended August 31, 2006, Morgan reported, "Institutional Securities delivered its best third quarter results ever, with net revenues of $5.0 billion and income before taxes of $2.0 billion, up 55 percent from last year."
- For the fourth quarter and year ended November 30, 2006, Morgan reported "Institutional Securities delivered its best full-year results ever, with record net revenues of $21.6 billion and record income before taxes of $8.2 billion, up 72 percent from last year."
- For the first quarter of 2007, ended February 28, 2007, Institutional Securities

> achieved record net revenues of $7.6 billion, up 37 percent from last year. Pre-tax income rose 71 percent to a record $3.0 billion and return on average common equity was 40 percent.

96. Morgan entered into the Second Quarter of fiscal 2007 (March 2007 through May 2007) with reported "record results across the board." These results included record revenues, net income and EPS for First Quarter of fiscal 2007, which largely had outperformed expectations owing to what Defendants described as "disciplined and balanced" increased risk taking and strong trading performance. Significantly, Defendant Sidwell reported that fixed income sales and trading had contributed $3.6 billion in revenues, which he stated was the Company's best quarter ever and was owed in large part to results from Morgan's credit products area and favorable positioning in the sub-prime mortgage markets.

97. As can be seen on the graph below, the proportion of Morgan's reported revenues derived from the ISG (Trading and Principal Transactions) skyrocketed as compared to Morgan's other business divisions, following Mack's risk embracing initiatives:



D. <u>Defendants Assure Investors That Morgan's Risk-Taking is "Disciplined"</u>

98. Morgan's blockbuster financial results over the one-year period after Mack had implemented his new risk-embracing business model, raised questions among analysts and investors as to whether the Company was safely managing its risk. These inquiries were repeatedly met with assurances that the Company's risk taking was measured and disciplined.

99. A power point presentation by Tom Daula to investors in February 14, 2006, titled "Risk Management at Morgan Stanley An Overview," outlined the procedures that Morgan supposedly had in place to monitor trading risks. The "Risk Controls," identified by the report included:

> Mark to market discipline
> - Ensure revenues more closely track economics
> - Critical components
>   - Independent review by Controllers
>   - New Model Approval process
>
> Backtesting (i.e. the comparison of realized trading revenues against Value-at-Risk results)
> New product review processes
> Limits
> - Established at various levels throughout the Firm from trader to business and are defined in terms of risk sensitivities, concentrations and portfolio exposures
> - Generally set at levels to ensure that a material change in risk triggers a discussion between the trader or trading desk and management

100. Moreover, the report detailed an elaborate protocol for communicating risks to risk managers that included: "daily discussion with trading desks; daily comprehensive risk reports, weekly summary report and risk committee meetings; quarterly and annual reviews and regulatory reporting; [and] reporting to Audit Committee."

101. The successful implementation of such risk management protocols were reiterated by Defendants in their representations to investors. For example, during the March 21, 2007 earnings call, announcing the Company's record results for the first quarter of 2007, Defendant Mack attributed these results to the Institutional Securities Group, run by Zoe Cruz, and its "effective, disciplined risk taking." Likewise, at the Company's annual meeting in April 2007, Mack attributed the Company's exemplary performance to the Institutional Securities division's ability to "manage a tremendous amount of risk in a smart and disciplined way."

102. These assurances were also repeated by Mack in response to an inquiry from a shareholder at Morgan's April 21, 2007 Shareholder Meeting, asking whether Morgan was safely assuming risks in order to produce its reported record results. John Mack responded to the question:

> Well, number one, I think this firm has the capacity to take a lot more risk than it has in the past. So from that aspect, we're really using our talent in a more productive way than we have had in the past. I am comfortable with the risk...I think we probably have one of the best overall risk managers in Tom Daula, who oversees all firm risk, and also Zoe growing up on the sales and trading side, mainly trading side risk management, it's a very strong combination. So I'm comfortable with it.

103. During the Class Period, in the Company's quarterly reports filed with the SEC on Form 10-Q on July 10, 2007 and October 10, 2007, the Company made a series of additional representations regarding its risk reporting structure and risk management system. The Company asserted in these regulatory filings that its risk managers and valuation experts operated "independently" of the managers and traders who were taking on the risk. Specifically, Morgan stated that "reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks" and that "groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate."

104. In addition, the Company's 2007 quarterly filings incorporated language from Morgan's 2006 Form 10-K which stated that "Company Control Groups...are all independent of the Company's business units."

105. Likewise, the Company also touted the purported effectiveness of its risk mitigation strategy as it specifically pertained to the Company's exposure to credit default swaps and other derivative contracts, noting in its Second Quarter 2007 10-Q that:

> Aggregate market risk limits have been established, and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies, including, but not limited to, entering into offsetting economic hedge positions. The Company believes that the notional amounts of the derivative contracts generally overstate its exposure.

106. Defendants continually reaffirmed Morgan's effective risk management strategies in

conference calls with analysts and investors as well. During the Company's first quarter conference call on March 21, 2007, Defendant Sidwell stated that the firm's increased risk-taking endeavors were being managed "in a disciplined and balanced way."

107. Given Morgan's outstanding results and its assurances that these results were being obtained through disciplined and effective risk controls, analysts and investors were highly enthusiastic about the Company's prospects, as against its peers.

108. On April 11, 2007, Deutsche Bank initiated coverage on Morgan with a "Buy" rating and a 12-month price target of $101 per share. Analysts at Deutsche Bank noted that Morgan had taken more risk with trading and principal investments, while also stating that the Company was not "betting the bank" with its investments. The Deutsche Bank analysts reported that Morgan was "hedged properly" during difficulties in the subprime segment in February 2007. The research report further stated that Morgan's higher level of risk needed to be monitored and emphasized that the Company's CEO had emphasized "taking additional risk when there is a reasonable return." The analysts also reported that Morgan's head of risk management sat on the Company's management committee.

109. Analysts at Deutsche Bank issued a research report on May 10, 2007, following their meeting the same day with CEO, defendant Mack. Reiterating their "Buy" rating on Morgan, the analysts reported that factors driving the Company's growth included "better capital allocation/optimization of the balance sheet" as mandated by the CFO, and "more principal activity" with a "gradual[] increase" in the amount of trading risk. The research report further stated that Morgan was looking to increase the degree of principal risk taking to try to bridge the gap in the Company's performance, which lagged behind "best-in-class Goldman Sachs."

E. Undisclosed to the Investing Public, Morgan's Proprietary Trading Group Makes a Multi-Billion Dollar Bet on the Movement of U.S. Subprime Securities

110. In December 2006, Morgan's Proprietary Trading Group, armed with information from Morgan's acquisition of Saxon Capital, a subprime mortgage originator that Morgan had acquired in August 2006 to build its mortgage backed securitization business, structured a large bet on the movement of CDSs referencing tranches of CDOs as explained below, linked to subprime

RMBSs.

111. To understand Morgan's bet necessitates a brief overview of the complex financial instruments—CDSs, CDOs, and RMBSs—upon which this bet was made.

1. <u>The Residential Mortgage Backed Securities, Collateralized Debt Obligations and Credit Defaults Swaps Behind the Proprietary Trading Group's Bet</u>

112. At the height of the real estate boom that peaked in 2005, investment banks were among the largest purchasers of U.S. residential mortgages in the secondary market, due to the fact that through a lucrative process known as securitization, firms like Morgan were able transform individual mortgages into high-yielding bonds and other financial instruments, which could then be sold to outside investors. The demand for these high-yield bonds, in turn, fueled a demand for mortgages that could be pooled together and securitized. To satisfy this need for mortgages for securitization, mortgage originators increasingly turned to less traditional, higher risk borrowers, and thus created a swell of so-called subprime mortgages. Through various forms of financial engineering, these subprime mortgages were turned into investment grade securities, and then sold to a variety of investors, or, in turn, created into other financial instruments.

113. Among the financial instruments that Morgan and other financial institutions created from mortgages were RMBSs and CDOs. To create an RMBS, investment banks purchased a large number of individual mortgages from bank and/or non-bank mortgage lenders. Once the bank purchased a sufficient number of mortgage loans, it then pooled the mortgages together and sold them to a "special purpose vehicle" ("SPV"), which is a separate, bankruptcy-remote legal entity created in order to transfer the risk of the underlying mortgages off the originator's balance sheet.

114. The SPV then divided the mortgage pool into "tranches," or slices, by prioritizing payments and apportioning losses in connection with the underlying pool of mortgages. Once the tranches were created, the underwriter then issued a series of bonds corresponding to each of the tranches. Through the prioritized payment structure, the SPV was able to issue bonds with an array of credit ratings, ranging from AAA to below-investment grade. Typically, the AAA rated bonds received first priority on cash flows from the borrowers on the underlying mortgages but received a lower yield on the investment, reflecting less reward for less presumed risk. Conversely, the below

investment-grade tranche holders received a higher return on their investment because they absorbed the first losses in the event that the mortgages in the underlying pool defaulted. Under the typical payment structure, the AAA rated RMBS bonds would only experience losses after all tranches below it in the payment structure had been completely wiped out.

115. Once a payment schedule was agreed upon and the ratings were assigned to the various RMBS tranches, the SPV sold the resulting RMBS to investors. The SPV transferred proceeds from the sale of the bonds to underwriters like Morgan in consideration for the underlying collateral.

116. As stated above, investment banks also used mortgages as the fundamental building blocks in creating CDOs. In essence, CDOs are very similar to RMBSs. The main difference between the two instruments is that while the underlying collateral of an RMBS consists of mortgages, the underlying collateral of CDOs consists of RMBSs.

117. In addition to RMBSs and CDOs, an extremely active market for credit default swaps or CDSs referencing RMBSs and CDOs emerged during this time period. A CDS is a credit derivative contract between two counterparties. The *buyer* makes periodic payments to the *seller*, and in return receives a payoff if an underlying financial instrument defaults.

118. CDS contracts have been compared to insurance. The "protection seller" provides the "protection buyer" with insurance against the risk of loss in the referenced asset, while the protection buyer agrees to provide the protection seller with regular premium payments. In the event of default, the protection seller usually agrees to either (1) take possession of the referenced asset at face value or (2) pay the protection buyer the difference between the bond's par value and the recovery amount on the bond.

119. The protection seller is, thus, taking a long position with respect to the referenced asset, since the protection seller is betting that the default rate will be low and that the losses suffered by the holder of the mortgage, RMBS or CDO position will be minimal. The protection buyer is shorting the referenced asset in order to hedge against the risk of loss, since the protection buyer is betting that the asset will experience at least some amount of losses.

120. While this is how a CDS works in theory, in practice, however, because the

protection buyer of a CDS does not need to own the underlying security on which insurance is being bought, the buyer does not even have to suffer a loss from the default event. Thus, a CDS is often use as a speculative investment betting on the risks relating to the underlying bonds or securities on which the CDS is based by the buyer of the insurance.

121. Additionally, investment banks like Morgan often would pool individual CDSs together, divide them into tranches, and sell bonds referencing those tranches to investors. These financial instruments were commonly referred to as synthetic CDOs.

2. The Proprietary Trading Group's Massive Bet on the Price Movements on CDSs referencing CDOs

122. The Proprietary Trading Group's massive bet involved taking on a short position in the subprime mortgage market by purchasing CDSs referencing the lowest-rated tranches of subprime based CDOs. Because defaults in the underlying CDO tranches would trigger payments to the Company under the CDSs, this position was designed to increase in value as the value of lower-rated CDO tranches declined.

123. In taking the short position, the Proprietary Trading Group was obligated to make periodic payments to its CDS counterparties. To offset the cash outlay associated with buying this position, Morgan purchased an economic hedge by taking a long position in certain interest-bearing mortgage-backed assets. Specifically, the Proprietary Trading Group's traders sold CDSs on approximately \$13.2 billion worth of AAA rated, super senior synthetic CDOs backed by mezzanine (BBB+ or BBB-) collateral. Because the Company sold default protection on these mezzanine CDO tranches, it received periodic premium payments from its CDS counterparties, which it used to finance the short position. The long position on these super senior CDO tranches exposed the Company to \$13.2 billion in potential losses in the event of a 100% default scenario on the underlying CDO tranches.

124. The essence of Morgan's Proprietary Trading Group's subprime-related position was not disclosed to the investors and the markets, until, as alleged herein, the Company was forced to disclose this position on November 7, 2007. The transaction was explained by the *Financial Times* in a November 8, 2007 article, following the Company's forced disclosure, as follows:

> The [Morgan Stanley] traders had a good idea at the time. Back in December [2006] there were signs that serious problems were developing among U.S subprime mortgage borrowers, but the prices of securities based on such loans were holding up well. So they placed a big bet on a fall in those prices. To do so, they bought insurance against problems with the mortgage-backed securities in the form of credit default swaps. The value of these would rise if the outlook for the securities deteriorated.
>
> To help fund this [short] bet, the traders also took on billions of dollars of exposure to the "super senior" tranches of collateralized debt obligations. These are instruments composed of mortgage-backed securities divided into slices with varying yields and risks. The top AAA-rated tranches were seen as being very safe, because any likely losses on the underlying securities would be absorbed by investors in the lower tranches. Nevertheless, the senior tranches offered a good yield which helped off the cost of the [short CDS] bet.

125. The Proprietary Trading Group's strategy exposed the Company and its investors to an excessive amount of undisclosed risk of losses and these positions began losing value mid- to late-2007 as the subprime mortgage market began to collapse.

126. In taking both long and short positions, Morgan was essentially betting that subprime mortgage defaults would be significant enough to impair the market value of lower tranches of CDOs which were built from subprime RMBSs, but not significant enough to impair the value of AAA rated, super senior tranches of the same or similar CDOs, also built from the same subprime RMBSs.

3. <u>Generally Accepted Accounting Principles Required that the Proprietary Trading Group's Trading Position Be Valued at "Fair Value" on Morgan Stanley's Balance Sheet</u>

127. Morgan's trading position held by the Proprietary Trading Group, described above in ¶¶ 122-126, involved both the purchase and sale of credit defaults swaps and the accounting for these positions were subject to specific accounting rules under generally accepted accounting principles ("GAAP"). As a publicly-traded company, Morgan was required to maintain and report its financial statements in accordance with GAAP.

128. On the first day of the Company's fiscal 2007, December 1, 2006, Morgan adopted a financial accounting standard known as SFAS No. 157, *Fair Value Measurements*, which established a framework, referred to as the "fair value hierarchy," for measuring "fair value" of the Company's trading positions, including the CDS held by the Proprietary Trading Group. SFAS No. 157 was issued by FASB in September 2006 to increase consistency and comparability in fair

value measurements. The application of SFAS No. 157 was described as follows by the Company in its Second Quarter Form 10-Q filed with the SEC on July 10, 2007:

> Effective December 1, 2006, the Company early adopted SFAS No. 157 and SFAS No. 159, which require disclosures about the Company's assets and liabilities that are measured at fair value.
>
> ***
>
> The Company's assets and liabilities at fair value have been categorized based upon a fair value hierarchy in accordance with SFAS No. 157. The levels of the fair value hierarchy are described below:
>
> - Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Financial assets and liabilities utilizing Level 1 inputs include active exchange-traded equity securities, listed derivatives, most U.S. Government and agency securities, and certain other sovereign government obligations.
>
> - Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Financial assets and liabilities utilizing Level 2 inputs include restricted stock, infrequently-traded corporate and municipal bonds, most over-the-counter derivatives and certain mortgage loans.
>
> - Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. Financial assets and liabilities utilizing Level 3 inputs include real estate funds, private equity investments, certain commercial mortgage whole loans and complex derivatives, including certain foreign exchange options and long dated options on gas and power.
>
> In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

129. As indicated by Morgan, under SFAS No. 157, "fair value" is defined as the amount at which financial instruments could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. In determining fair value, FASB No. 157 establishes a hierarchy that calls for the maximization of the use of "observable inputs" to value assets and liabilities and minimizes the use of "unobservable inputs" by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in

pricing the asset or liability developed based on market data obtained from sources independent of the Company.

130. Fair value accounting under SFAS No. 157 requires the adoption of strict internal controls to ensure that the assessment of fair value is done consistently and transparently. In Morgan's 2007 Second Quarter 10-Q, it described the internal controls the Company had purportedly adopted to ensure its compliance with SFAS No. 157:

> The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable market prices or market–based parameters wherever possible. In the event that market prices or parameters are not available, the control processes are designed to assure that the valuation approach utilized is **appropriate and consistently applied and that the assumptions are reasonable**. These control processes include reviews of the pricing model's theoretical soundness and appropriateness **by Company personnel with relevant expertise who are independent from the trading desks.** Additionally, **groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate.** Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model. [Emphases added.]

4. <u>The ABX Index Was an Observable Market Input That Impacted the Fair Value of the Assets Underlying the Proprietary Trading Group's Trade</u>

131. The Proprietary Trading Group's trading position involved credit default swaps referencing the "super senior" tranches of so-called "mezzanine" rated CDOs, which were built on BBB rated U.S. subprime residential mortgage backed securities. At its core, therefore, the trading position was linked to the performance of U.S. subprime mortgages.

132. In January 2006, several investment banks that were market-makers in asset backed securities, including Morgan, collaborated with Markit, a financial information services company, to create an index known as the "ABX Index," whose sole purpose is to track the value of securities collateralized by U.S. subprime mortgages. During the Class Period, the ABX Index tracked the performance of 15 to 20 equally-weighted RMBS tranches backed by U.S. subprime mortgages by monitoring the pricing of CDSs referencing those RMBS tranches. The ABX Index was, and still is, used by market participants as a barometer for assessing the performance of subprime-related

securities in the marketplace.

133. As noted above, the ABX Index tracked the cost of buying and selling CDS protection on selected RMBS tranches. Each of the 15-20 RMBS tranches had a different rating, from AAA to BBB- and was considered a representative sample of other MBS tranches backed by subprime collateral with the same rating.

134. The various series of the ABX Index are organized by vintage (*i.e.*, the year that the underlying subprime collateral was issued). For example, the ABX Index 06-1 series tracks CDSs referencing subprime RMBS tranches that were originated in the second half of 2005, while the 06-2 series tracks CDSs referencing subprime MBS tranches that were originated in the first half of 2006. As the trend suggests, new indices are rolled out every six months. During the Class Period, there was an ABX Index for every vintage (from 2006 onwards) and rating of subprime collateral for which a significant amount of CDOs had been issued and were outstanding.

135. As set forth in greater detail below, as investors would discover at the end of the Class Period, the Proprietary Trading Group's trade, and specifically the value of the $13.2 billion long position it assumed, was linked to the movement of the ABX.HE.BBB 06-1 series. A sample table for this series, as of February 23, 2007, is set forth below:

Index Series	**Version**	**Coupon Rate**	**RED ID**	**PRICE**	
				Low	**High**
ABX-HE-BBB 06-1	6 1	154	0A08AIAA4	88.50	101.20

136. In the table above, "Series" refers to the type of loan ("HE" or Home Equity), the bond's credit rating (e.g., BBB), and the vintage of the referenced MBS (e.g., 06-1).

137. "Coupon Rate" sets the premium payment (measured in basis points) that a protection buyer agrees to pay a protection seller over the life of the CDS. For example, assuming a CDS notional value of $100 million, a Coupon Rate of 154 on the ABX-HE-BBB 06-1 means that CDS protection on a BBB-rated RMBS tranche issued during the second half of 2005 would cost roughly $1.54 million.

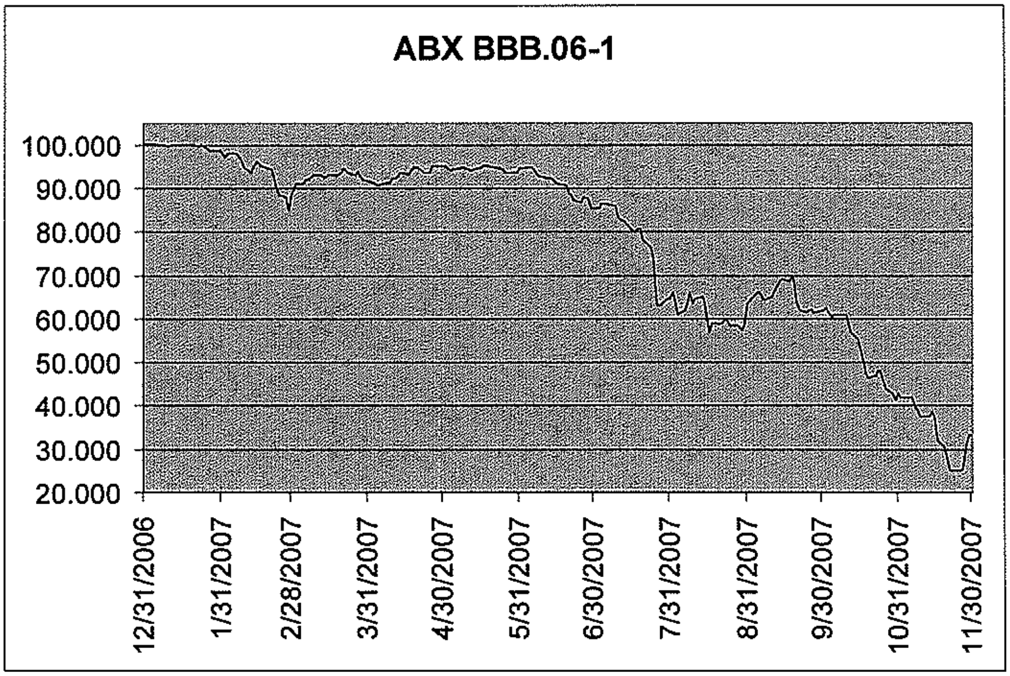
138. "Price" is the cost of buying the CDS referencing a specific subprime RMBS. The price is set to 100 on the day the particular Index is launched and equal to 100 cents on the dollar.

At 100, the only payment made by the protection buyer to the protection seller is the Coupon Rate. If the Index drops below 100, however, it means that purchasing CDS protection is becoming more expensive because protection sellers are demanding an additional premium payment. The amount of the additional premium is expressed by the amount by which the Index drops below 100.

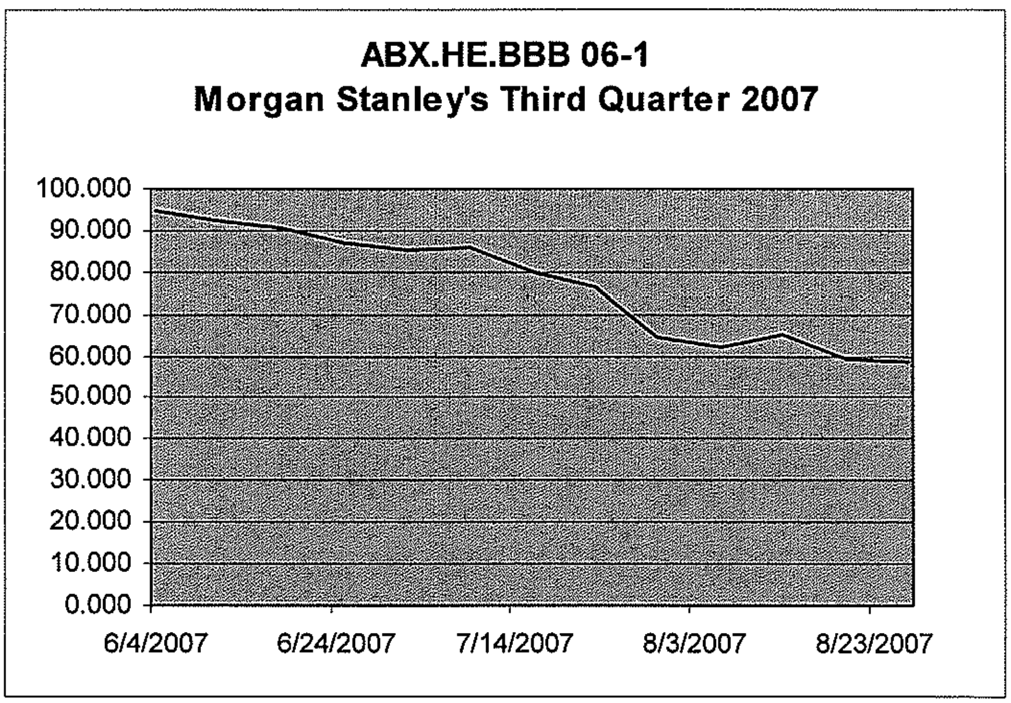
139. By way of example, as of February 23, 2007, the ABX-HE-BBB 06-1 was trading at 88.5, an 11.5% discount from its 100 par value. This means that, as of this date, protection sellers were demanding an 11.5% up-front fee from protection buyers in addition to the above-referenced coupon payment. In the $100 million example above, this would translate into an up-front fee of $11.5 million, in addition to the $1.54 million coupon payment that will be made over the life of the contract.

140. By tracking the level of additional premiums required by protection sellers, the level of the ABX Index indicates market sentiment as to the likelihood that certain assets backed by subprime mortgages will experience future losses. The larger the upfront premium required by the protection sellers—reflected by the amount the price is below par—the more likely the market believes that such assets will experience future losses. Thus, the ABX Index reflected the value of CDSs referencing MBSs, as the subprime crisis unfolded throughout 2006 and 2007. As a result, industry experts utilized the ABX Index to assess the value of subprime-backed MBSs and CDOs. On July 19, 2007, Bloomberg.com stated that the "ABX Indexes have been watched by investors in everything from U.S. treasuries to foreign stock as a way to track the collapse of the subprime market." Further, on July 10, 2007, Deutsche Bank issued a report stating that "the ABS CDO market was shaken in the wake of the recent ABX index collapse." In fact, during the period from 2006 through 2007, Defendants knew or recklessly disregarded that the ABX Index was even more probative of the market value of U.S. subprime-related CDSs, since CDSs are the precise instruments tracked by the Index.

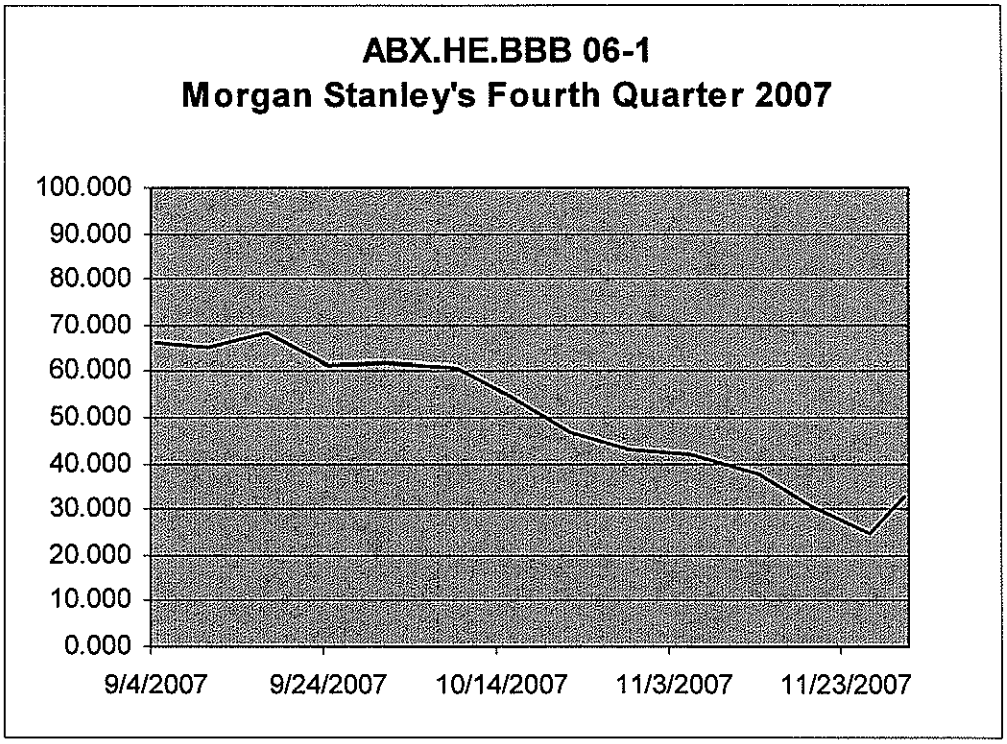
141. As set forth in the chart below, the value of the ABX.HE.BBB 06-1 series declined sharply during 2007, evidencing the declining value of subprime-related CDSs due to the increased risk of having to reimburse protection buyers for losses suffered on the MBS positions:



142. During Morgan's third quarter, June 1, 2007 through August 31, 2007, the ABX BBB.06-1 Index, declined 32.8 % from 94.5 to 63.5. This dramatic drop is illustrated on the chart below:



143. In Morgan's fourth quarter, September 1, 2007 through November 30, 2007, the ABX BBB.06-1 Index fell another 50% from 66.0 to 33.0, as illustrated below:



144. In fact, Morgan itself has repeatedly acknowledged that the proper measure of value for its CDSs is, first and foremost, the ABX Index. During the November 7, 2007 conference call, Defendant Kelleher stated that the decline in fair value of its CDS positions was "*due to* the sharp decrease in the BBB ABX price indices." Similarly, the chart attached to the Company's November 7, 2007 press release stated that in valuing their subprime mortgage-related positions, the Company took into consideration "the continued deterioration in market data, *as reflected by* the sharp decline in the ABX indices." (Emphases added).

145. The AICPA Center for Audit Quality has stated in a white paper titled "Measurements of Fair Value in Illiquid (or Less Liquid) Markets," that the ABX Index is a suitable Level 2 input to value *bonds* backed by subprime mortgage loans under SFAS No. 157. As a consequence of the above-described trading position entered by the Proprietary Trading Group on Morgan's behalf, Morgan owned actual CDSs referencing subprime mortgage-backed securities, the identical instruments tracked by the ABX Index. Thus, if the Index is a suitable valuation input

for valuing bonds backed by subprime loans, it is the absolute basis for valuing CDSs referencing subprime loans, such as the ones in which Morgan's Proprietary Trading Group had invested.

146. Furthermore, another authoritative body, the Bank for International Settlements, a commercial banking standards setting entity, holds that the ABX Index values are so controlling, that "to obtain estimates of mark-to-market losses for subprime MBS, ABX prices, by rating and vintage, can simply be applied to outstanding volumes of these securities." Additionally, the industry standard in tracking and valuing subprime-related CDSs is the ABX index. As Citigroup CFO Gary Crittendon stated, "the best way to get an outside perspective on [CDS values] is to look at the ABX Indices."

5. <u>The Declines in the ABX Index Were Linked to the Declines in the U.S. Subprime Markets</u>

147. During the Class period, as discussed below, the Defendants knew and/or recklessly disregarded that the decline in the ABX Index was directly correlated to the decline in value of CDSs referencing subprime mortgage-backed securities, the same assets Morgan held on its books.

148. Beginning in 2006, massive amounts of new construction and the after-effects of the surge in home purchases over the previous decade began to drive U.S. housing price appreciation rates down. Eventually, housing prices started to fall. This occurred at a time when interest rates were high and just as many ARM "teaser" rates were set to expire. These market conditions created a perfect storm for U.S. mortgagors, particularly those who received subprime mortgages.

149. The expiration of the "teaser" rates meant that the monthly mortgage payments for many mortgagors became adjustable, and higher interest rates ensured that those monthly payments would increase dramatically. Further, higher interest rates precluded borrowers from refinancing, and falling home prices left those borrowers with little, if any, equity in their homes. As a result, default and foreclosure rates rose precipitously as an increasing number of borrowers became unable to meet their mortgage obligations. By way of example, data published by RealtyTrac in January 2008 showed that the 215,749 foreclosure filings reported in December 2007 was nearly double the number of foreclosures reported just a year earlier.

150. The financial conditions plaguing the broader mortgage market were particularly

troublesome for subprime mortgagors who over-extended themselves when purchasing their home during the housing boom. In December 2006, the Center for Responsible Lending released a report predicting that a staggering 20% of all subprime loans issued during 2005 and 2006 would enter into foreclosure, amounting to 2.2 million homes and approximately $164 billion in value. Further, between the fourth quarter of 2006 and the fourth quarter of 2007, the subprime mortgage delinquency rate increased nearly 48%, rising from 11.70% to a staggering 17.31% during the year.

151. The rapidly deteriorating credit quality of subprime mortgages issued during the housing boom had a devastating effect not only on subprime borrowers, but also on the subprime originators that made these high-risk loans. As subprime default rates began to rise and losses mounted, investor demand for securities backed by subprime mortgage collateral declined. As a result, investment banks became less willing to purchase mortgage assets from subprime originators, leaving many of those lenders with a host of risky mortgage assets on their balance sheets and without major sources of financing. Accordingly, many mortgage lenders were forced to suspend operations and/or seek bankruptcy protection during this time period.

152. For example, on February 7, 2007 New Century Financial Corporation, the country's second largest subprime originator, announced it needed to restate results due to increased losses on defaulted subprime mortgage loans. The following day, HSBC Holdings PLC, one of the world's largest banks and non-prime lenders, announced an increase of approximately $10.6 billion in bad debt charges for 2006 due to increased troubles in the subprime mortgages market. Further, subprime mortgage lender Fremont General Corporation ceased issuing subprime mortgages on March 2, 2007. Shortly thereafter, another subprime originator, People's Choice Home Loan, Inc., filed for bankruptcy protection.

153. On March 31, 2007, as the subprime crisis continued to worsen, New Century was forced to file for bankruptcy protection after many of its lenders ceased doing business with New Century.

154. Eventually, the subprime mortgage crisis naturally extended beyond subprime borrowers and mortgage lenders, and reached the secondary mortgage market participants. Because the market values of MBSs and CDOs referencing residential mortgages are dependent

upon the individual mortgagors' ability to repay their home loans, the increase in mortgage defaults negatively impacted the value of mortgage-backed securities and CDOs, particularly those backed by subprime-mortgage collateral.

155. As stated above, as mortgage losses mounted, investors began to shy away from securities backed by subprime mortgage collateral. This left the investment banks like Morgan, which had voraciously purchased and securitized mortgage assets during the real estate boom, holding billions of dollars in illiquid subprime mortgages and MBSs on their books. As defaults mounted, Defendants knew or recklessly disregarded that the fair value of these assets declined markedly, yet failed to disclose these positions to investors. Likewise, the value of CDSs referencing subprime mortgage-backed securities similarly declined, as it became more likely that protection sellers would be obligated to make payments to their counterparties. As a result, investment and commercial banks including, *inter alia*, Citigroup, Merrill Lynch, and UBS recognized billions of dollars in losses associated with these assets.

156. Further, on July 17, 2007, despite receiving a $3.2 billion bailout, two subprime hedge funds run by the Bear Stearns Companies Inc., the Enhanced Leverage Fund and the High-Grade Fund, that invested in CDOs linked to U.S. subprime securities, informed investors that there was "effectively no value left for the investors in the Enhanced Leverage Fund and very little value left for the investors in the High-Grade Fund." Ultimately, both the Enhanced Leverage Fund and the High-Grade Fund collapsed on July 31, 2007. As creditors attempted to liquidate the Bear Stearns' holdings in the open market they were faced with virtually no liquidity and no willing buyers of these assets. As a result of this very public failure of a subprime-linked hedge fund, a massive re-pricing of subprime mortgage-backed securities occurred, causing numerous investment banks and hedge funds with subprime exposure to significantly reduce the value of their subprime portfolios in the third quarter of 2007.

157. Morgan was not among these banks that disclosed losses due to subprime mortgage-related exposure during the period. In fact, the shareholders and investors had been led to believe that Morgan had minimal subprime exposure.

VII. DEFENDANT'S FRAUDULENT SCHEME TO CONCEAL KNOWN LOSSES CAUSED BY THE PROPRIETARY TRADING GROUP'S SUBPRIME BET AND OTHER SUBPRIME POSITIONS HELD BY THE COMPANY

158. Although, as set forth above, a sharp decline in the subprime mortgage market would leave the Company exposed to billions of dollars in potential subprime-related losses, Defendants failed to disclose the existence of the Company's subprime positions, and the immense risk associated with holding such investments, during the Class Period.

159. Throughout the first two quarters of 2007, default rates in subprime mortgages had risen to unprecedented levels, drastically reducing the market value of lower-rated subprime mortgage-backed securities. Further, as rising defaults eroded the credit protection that had been afforded to higher-rated AA and AAA securities, they too became more susceptible to reductions in value. As such, Defendants knew or recklessly disregarded that Morgan had become increasingly exposed to massive subprime-related losses by virtue of the extremely concentrated subprime investment made by the Proprietary Trading Group.

160. Nevertheless, as set forth below, during its conference calls and in its quarterly SEC filings for First Quarter 2007 and Second Quarter 2007, despite requests by analysts for disclosure concerning the Company's exposure to the U.S. subprime market, the Company failed to provide investors with any degree of transparency regarding the nature and extent of Morgan's subprime exposure during this time period, even though the Proprietary Trading Group had exposed the Company to billions of dollars in losses related to movements in the value of subprime securities. Nor did the Company reveal that it also held other subprime assets on its balance sheet. Instead, the Company repeatedly informed investors that while it possessed certain subprime-related assets, it was "well-positioned" to withstand a deterioration of the subprime market and was adequately hedged against subprime so as to not suffer any losses.

A. <u>Defendants Disclaim Any Exposure to the Declines in the Subprime Market</u>

161. At a time when the U.S. subprime loan market seemed like a sinking ship - its casualties increasing at an unprecedented pace – Morgan appeared to be not only impervious to the growing crisis, but also swimming in profits from Defendants' self-described "well-balanced" risks. While reporting earnings for First Quarter 2007, on March 21, 2007, Defendant Sidwell

expressly acknowledged that subprime had been a key focus in the market during early March 2007, and he stated that the Company managed its risk through a variety of hedging strategies and proprietary risk positions that had "significantly contributed" to Morgan's record results. Defendant Sidwell further reported that the Company had decreased risk exposure during the latter part of the First Quarter 2007 to balance Morgan's level of risk with Defendants' view of potential market changes. In response to analysts' questions, Sidwell acknowledged that its acquisition of Saxon Capital, and increased participation in mortgage origination had provided "key insights" into understanding where investment opportunities were and where the markets were heading.

162. While Sidwell disclosed during the March 21, 2007 conference call that Morgan participated in numerous aspects of the subprime mortgage market, including both originations and proprietary trading, he stated that subprime concerns would be a "reasonably limited event," and even attributed the Company's record first quarter performance, in part, to its subprime trading strategies. Defendant Sidwell stated, in relevant part:

> In fixed income sales and trading, $3.6 billion in revenues was our best quarter ever, up 57%, driven by broad-based strength across credit products, interest rate, and currency products and commodities... Looking at the results by product area, credit products rose 110% to a new record, ***with the largest increase in securitized products driven by favorable positioning in the sub-prime mortgage market***, strong customer flows, and robust growth in our Global commercial mortgage business. (Emphasis added).

163. When analysts and investors questioned whether the Company was truly well-positioned and requested further details regarding its subprime mortgage exposure, however, Defendants refused to provide the market with additional transparency, stating during the March 21, 2007 conference call that they "don't really want to address specifically how [Morgan is] positioned [in the mortgage market]."

164. The Defendants continued to downplay and conceal Morgan's risks to subprime-related losses in the second quarter of 2007 despite the rapidly deteriorating credit quality of subprime-related mortgages and the market-wide fear that companies with subprime exposure would be forced to recognize massive losses.

165. On June 20, 2007, during the Company's second quarter conference call, Sidwell again discussed the subprime market with analysts and investors, but he did not disclose Morgan's

exposure to any decline in the value of U.S. subprime mortgage securities. Instead, Sidwell merely assured the analysts and investors on the call that the Company "certainly did not lose money in [the subprime mortgage] business" during the second quarter.

166. Defendants' optimistic statements regarding the Company's subprime mortgage exposures during the first half of 2007 caused analysts, investors and ratings agencies to believe that the Company's subprime mortgage-related exposure was controlled, and that Morgan was well-positioned, especially compared to its peers, to escape from the mortgage market meltdown relatively unscathed. For example, on March 21, 2007, Keefe, Bruyette & Woods analyst Lauren Smith raised her 2007 earnings estimate for the Company to $8.12 from $7.20 per share. In so doing, Smith stated she believed the Company would "more than stand up to the perils we are witnessing in the sub prime mortgage market." Smith also pointed out that "[m]anagement noted they feel very confident in how they are positioned and their exposures to the sub prime mortgage markets."

167. Likewise, on July 30, 2007, S&P upgraded Morgan's credit rating from A+ to AA-. While S&P was undeniably aware of the rapid reduction in the value of subprime-related securities during the first half of 2007, it noted that "Morgan Stanley's exposure to the U.S. subprime mortgage sector and leveraged corporate finance sector is under control." S&P further justified the upgrade by stating that Morgan's "strong competitive position leaves it better able to withstand market volatility in comparison to its peers."

B. <u>The SEC's Request for Greater Disclosure of the Company's Exposure to Subprime is Undisclosed and Ignored</u>

168. As conditions within the subprime market worsened, the Company's lack of any discussion of subprime exposure in its financial statements caught the attention of the SEC. In an August 30, 2007 letter from John Hartz, SEC Senior Assistant Chief Accountant, to David Sidwell, the SEC complained about the Company's failure to provide investors transparency regarding the Company's subprime-related positions as reported in the Company's 2006 Form 10-K on February 13, 2007 and First Quarter 2007 10-Q. This letter, and the subsequent correspondence between Morgan and the SEC, would only be disclosed well after the end of the Class Period, when the SEC

made the correspondence public. The SEC stated, in part:

> We note from the disclosures on page 4, 127 and 162 that you originate, trade, make markets and take proprietary positions in, and act as principal with respect to, mortgage related and real estate loan products. We further note on page 4 that in December 2006 you acquired Saxon Capital, Inc., a servicer and originator of subprime residential mortgage loans. We also note that you provide financing to customers for residential real estate loan products. It is unclear from your document the exposure you have to subprime loans.
>
> ***
>
> Based on your current public disclosures, it is possible that more clarity about your exposure to any subprime loans could be helpful. Regardless of the materiality of your exposure, we respectfully request that you provide us with supplemental information about your involvement in sub-prime loans.

169. Specifically, the SEC asked the Company to quantify, *inter alia*, its "portfolio of subprime residential mortgages," and to "breakout the portfolio to show the underlying reason for the subprime definition, in other words, subject to payment increase, high LTV ratio, interest only, negative amortizing, and so on." The Commission further requested that the Company quantify "the principal amount and nature of any retained securitized interests in subprime residential mortgages," its "investments in any securities backed by subprime mortgages," "current delinquencies in retained securitized subprime residential mortgages," and "any write-offs/impairments related to retained interests in subprime residential mortgages."

170. In the August 30, 2007 letter, the SEC requested that the Company provide this information "as of the end of [Morgan's] last full fiscal year and as of the most recent date practicable." The Company's fiscal third quarter of 2007 ended the following day, on August 31, 2007.

171. Despite this explicit instruction from the SEC, the Defendants did not increase Morgan's level of disclosures relating to the Company's exposure to the U.S. market in the Company's earnings release published on September 19, 2007, or in the Form 10-Q filed on October 10, 2007 for the third quarter 2007, ended August 31, 2007. While the Third Quarter Form 10-Q contained limited references to "subprime," it did not come close to setting forth Morgan's known exposure to losses in connection with subprime. To wit, the disclosures in Morgan's Third Quarter Form 10-Q referring to "subprime" were as follows:

> Total sales and trading revenues decreased 16% in the quarter ended August 31, 2007 from the comparable period of fiscal 2006. Sales and trading revenues were adversely affected by the difficult market conditions that existed during the quarter ended August 31, 2007. The credit markets deteriorated considerably over the course of the quarter with increased volatility, significant spread widening, lower levels of liquidity and reduced price transparency. These factors affected the leveraged lending markets, the effectiveness of hedging strategies, **subprime** mortgage markets, including the market for collateralized debt obligations, and other structured credit product markets. This credit environment significantly impacted the Company's corporate lending and credit sales and trading activities. In addition, such conditions contributed to increased volatility and deleveraging in the equity markets, which affected the Company's quantitative trading strategies.
>
> ***
>
> Lower revenues from the Company's residential and commercial mortgage loan activities also contributed to the decline in credit product revenues, reflecting the difficult market conditions referred to above, as well as continued concerns in the **sub-prime** mortgage loan sector."
>
> "Concerns about the impact of **sub-prime** loans caused the broader credit markets to deteriorate considerably over the course of the quarter, with increased volatility, significant spread widening and lower levels of liquidity and price transparency."
>
> [Emphases added].

172. In each instance, the term "subprime" was used to describe adverse conditions in the broader marketplace. None of the references in the Third Quarter 2007 10-Q links the troubles within the broader subprime market to the actual assets and liabilities held on the Company's books, particularly those assets and liabilities involved in the Proprietary Trading Group's massive trading positions, nor do they otherwise provide any transparency regarding the Company's subprime related exposures.

173. What the market participants did not, and could not, know was that at this time, the Company's balance sheet was littered with billions of dollars in high-risk net assets with direct exposure to the crumbling U.S. subprime market, assets that would eventually cause the Company to write down a staggering $9.4 billion at the end of the Class Period.

C. Contrary to the Defendants' Lack of Representations to the Market About Morgan's Exposures to Subprime, Defendants Had Sounded the Alarm Internally About Massive Subprime Losses

174. According to an interview Zoe Cruz gave to *New York Magazine* that was published on May 5, 2008, beginning in May 2007, she "started to worry" that the subprime mortgage market was primed for disaster.

175. Knowing that a devaluation of RMBSs would cause the Company to suffer major losses, Cruz acknowledged that she began overseeing the unwinding of billions of dollars in mortgage-related investments that Morgan's ISG held as investments. Cruz also began informing certain Morgan clients that they should avoid taking on mortgage-related positions in light of the subprime market's impending collapse.

176. Because she feared that the Company would be left exposed to a downturn in the subprime mortgage market, in May 2007, before the class period began, according to Cruz's accounting in the *New York Magazine* article, she ordered Defendant Daula, the Company's Chief Risk Officer, to run "stress tests" on the subprime CDSs acquired by the Proprietary Trading Group. Cruz stated that the stress tests were designed to calculate the amount of money the Company would lose based on various levels of deterioration within the mortgage market.

177. On June 20, 2007, no less than three weeks after Cruz contends she became extremely concerned about the future of the U.S. subprime mortgage market, as evidenced by her ordering of the stress tests on the CDS acquired by the Proprietary Trading Group, Defendants held a conference call for analysts and investors to discuss the Company's earnings for the second quarter of 2007. Once again, Defendants neglected to address the Company's subprime-related exposures during the Company's Second Quarter 2007 earnings conference call. Rather, Defendant Sidwell said, on the call, "[c]oncerns early in the quarter about whether markets in the sub prime market were going to spread dissipated."

178. On July 4, 2007, Daula purportedly informed Cruz that the Company could conceivably lose $3.5 billion on the Proprietary Trading Group's CDS positions. It is not known why it took an entire month to complete this stress test, according to Cruz's account in the *New York Magazine* article. Although Daula told Cruz that such a loss was unlikely, she told Daula and Neal Shear, "I don't care what your view of probability is. Cut the position." Despite Cruz's purported orders, however, no action was taken, and the position was not eliminated at that time.

179. Moreover, on July 10, 2007, six days after Daula told Cruz that the Company could lose $3.5 billion dollars on Hubler's subprime-related positions alone, the Company filed its Form 10-Q for the second quarter of 2007. The Second Quarter 2007 10-Q does not provide investors

with any additional transparency regarding the Company's subprime-related holdings. In fact, the Company's 181-page quarterly filing does not even contain the word "subprime," even though Defendants knew U.S. subprime markets were in a free fall and that the Proprietary Trading Group's "bet the wrong way" could potentially generate a $3.5 billion loss for the Company and its investors.

D. The Defendants Actively Conceal the Losses Resulting From the Proprietary Trading Group's Subprime Positions

180. By the close of the third quarter 2007, the Defendants were acutely aware of the impact of the deteriorating fair value of the Proprietary Trading Group's CDS position and the impact its write down to fair value would have on the Company's financial statements. Given the Company's adamant position taken through the first and second quarters of 2007 that it was managing its risk in a disciplined way and actually stood to benefit from the decline in subprime securities, due to favorable hedges it had taken (*see* ¶¶ 161-167, 227-236), reporting a massive loss as a consequence of a bad bet on subprime securities was out of the question.

181. Indeed, the Company, as set forth above, earned a one-notch credit upgrade from Standard & Poor's from A+ to AA-. In issuing the upgrade, S&P noted, "While we recognize that recent capital markets turmoil—precipitated by market issues in the subprime mortgage and leveraged corporate finance sector—could herald a period of much less favorable market conditions, we believe that structural improvements in Morgan Stanley's competitive position leave the firm especially well-positioned to withstand market volatility compared to industry peers."

182. Defendants knew that a credit downgrade would have had a devastating effect on Morgan's capital position. As disclosed by the Company in its third quarter 2007 quarterly filing, a one-notch downgrade by the rating agencies would have required the Company to post an additional $588 million to counterparties to shore up its obligations.

183. As discussed above, in ¶¶ 122-126, the Proprietary Trading Group, as is now known but was undisclosed to investors during the Class Period, took a $13.2 billion long position on CDSs referencing the mezzanine or BBB rated tranches of CDOs. In other words, the Company agreed to assume $13.2 billion of potential exposure to defaults in CDOs, in exchange for premium

payments. This long position was taken to finance the earlier acquisition of a short position on lower-rated subprime securities, the notional value of which has still yet to be disclosed by the Company. The Company acquired protection against default in the form of CDSs on lower level tranches of CDOs also underpinned by subprime securities. The fair market value of the $13.2 billion long position in CDSs was inherently linked to the movement of the ABX Index BBB 06-1, as was admitted by the Company towards the end of the Class Period.

184. Prior to May 31, 2007, as can be seen by the chart at ¶ 141, the ABX Index against which the CDS position was being valued had slowly declined 5.5 percent so that at the end of the second quarter 2007, the BBB 06-1 vintage stood at 94.5. Between May 31, 2007 and August 31, 2007, however, during Morgan's 2007 third quarter, the ABX Index for BBB. 06-1 vintage declined 32.8%. Moreover, during the same period, each of the other ABX Indices for CDSs backed by mezzanine collateral experienced percentage declines that were as large, or even larger, than the decline in the BBB 06-1 series. Such a severe decline required Morgan to write down the Proprietary Trading Group's position, consistent with the requirements of SFAS No. 157, by at least $4.4 billion, or 32.8% of its $13.2 billion position. This loss could not be tolerated. Indeed, Zoe Cruz, reportedly had informed Morgan's Board of Directors in August 2007 that, "We're going to be the best house in a deteriorating neighborhood."

185. To avoid recognizing the $4.4 billion in losses that should have been recorded in Third Quarter 2007, the Company did not value its CDSs based on the ABX Index. Instead, Defendants began wrongfully to use unobservable Level 3 inputs to contrive "fair values" for billions of dollars in assets and liabilities despite the fact that the ABX Index, which was considered a reliable Level 2 input for valuing subprime-related CDSs, provided the Company with a continuous supply of observable market data throughout the Class Period.

186. Because they involve the use of internal models and allow companies to exercise managerial judgment in arriving at an asset's fair value, Level 3 inputs are considered to be the most subjective and least reliable valuation inputs. For this reason, SFAS 157 states that, regardless of the category in which an asset is placed for disclosure purposes, the "valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the

use of unobservable inputs." SFAS 157 ¶ 21. In addition, SFAS 157 ¶ C86 states that "the reporting entity must not ignore information about market participant assumptions that is available within reasonable cost-benefit constraints."

187. As discussed above, SFAS No. 157 establishes a "fair value hierarchy" which prioritizes the various types of inputs that financial institutions should use to determine the fair value of its trading positions. These inputs are divided into three levels: Level 1, Level 2 and Level 3. As stated by the Company in its Third Quarter 2007 Form 10-Q, Level 1 inputs "utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access." These are, for obvious reasons, the most objective valuation inputs. Level 2 inputs, according to the Company, "utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability" such as quoted prices for "similar "assets" or "inputs other than quoted prices that are observable for that asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals." Conversely, Level 3 inputs are considered "unobservable inputs" such as "models" involving "judgment exercised by the Company."

188. Just as inputs are categorized as belonging to one of the three levels in the valuation hierarchy, so too the assets or liabilities for which values are derived from such inputs are also categorized as belonging into one of the three levels. However, because multiple inputs may be used to determine the value of an asset, and because the Levels of these inputs may vary, the Company noted that "the level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is <u>significant</u> to the fair value measurement in its entirety." Therefore, an asset or liability can be classified as Level 3 even if its value is determined primarily using Level 2 inputs, provided that at least one significant Level 3 input was used in the valuation process.

189. During the third quarter 2007 earnings conference call, Defendant Sidwell stated that "[g]iven the third quarter market dynamics, more instruments have become illiquid" and, as a result, "the level of financial assets categorized in Level 3, which is the most illiquid category, have increased." Sidwell said that while Level 3 assets constituted 5% of total assets and 2% of total

liabilities in the second quarter, he expected those percentages to increase to 8% and 3%, respectively, in the third quarter. This amounts to an increase of approximately $35 billion in Level 3 assets and $11 billion in Level 3 liabilities over the Company's second quarter 2007 figures.

190. As can be now be determined based on the facts that have since come to light following the Class Period, in examining the Company's disclosures in the third quarter of 2007, the $35 billion increase in Level 3 assets and $11 billion increase in Level 3 liabilities during third quarter 2007 must have included the subprime mortgage-related CDS positions held by the Proprietary Trading Group.

191. Sidwell stated during the conference call that derivatives, "primarily complex structured instruments," were a major component of the Company's Level 3 assets and liabilities. First, Sidwell stated during the conference call that derivatives, "primarily complex structured instruments," were a major component of the Company's Level 3 assets. Second, in describing which instruments were included in Morgan's Level 3 assets, the Third Quarter 2007 10-Q included, for the first time, "certain credit default swaps" and "instruments associated with the Company's credit products and securitized products activities" in its listing of financial instruments that were valued using Level 3 inputs. In prior reporting periods, the Company had never included "credit default swaps" in its description of Level 3 assets. Moreover, the categorization of such assets as Level 3 was repeated in the year-end 2007 10-K.

192. Defendants' reclassification of the Proprietary Trading Group's CDS positions to Level 3 demonstrates that, during the third quarter of 2007, the Company began using unobservable market data in order to value these positions for the first time. In doing so, Defendants were able to secretly manage Morgan's earnings and soften the blow of the ABX Index's steep decline by taking only $1.9 billion in write-downs (instead of $4.4 billion) and reporting earnings of $1.38 per share.

193. In this manner, Morgan was able to announce earnings precisely at the lowest end of Wall Street estimates for the Company. According to *Businessweek.com*, 15 analysts had established earnings estimates for Morgan for the third quarter. The consensus earnings estimate was $1.54 per share. The high end of the range was $1.86 and the low end was $1.38. Had the Company marked its assets and liabilities in line with observable market data, namely the ABX

Index, it would have taken an additional $2.5 billion in write-downs during the third quarter and would have missed the low end of Wall Street's estimates by a country mile.

194. It is clear that the reason the Company began using subjective Level 3 inputs to value its positions was to avoid recognizing mark-to-market losses on its mortgage-related assets and liabilities as required had the ABX Index properly been used as the observable input. Thus, the unnecessary introduction of Level 3 inputs into the Company's valuation methodologies during the third quarter of 2007 was instrumental to Defendants' fraudulent conduct.

195. It was impossible for even those watching closely to notice that Morgan was reclassifying assets and liabilities from Level 2 to Level 3, or even that the positions being reclassified were subprime-related and the true reasons for any reclassification were concealed. As a result, Defendants were able to continue to conceal the Company's exposure to massive subprime losses to meet Wall Street's expectations and to maintain its high credit ratings, thereby lowering its cost of capital and continuing its issuance and trading of financial instruments without disruption.

196. That the Defendants should have recorded Third Quarter 2007 write-downs in line with the deterioration of the relevant ABX Index is further made evident by the Company's own admissions at the end of the Class Period. When the Company finally revealed its losses associated with the Proprietary Trading Group transaction in reporting $9.4 billion of write-downs on December 19, 2007, Defendant Kelleher stated:

> Our writedown, reflecting the impacts of November, increased to $7.8 billion from $3.7 billion as of October 31, while our total net exposure decreased to $1.8 billion from $6 billion over the same period. Using consistent valuation methodology, the fair value of these positions declined from October 31 to November 30. Our valuation of these positions takes into consideration observable trades to continue deterioration and market conditions, ***the decline in the ABX indices***, and other market developments including updated mortgage remittance and cumulative loss data. The decrease in the fair value of our subprime exposures has lead to our first quarterly loss.
>
> The trades we observed were those we executed in November as part of our effort to reduce our exposure. ***The ABX deterioration in the class of super senior positions, mainly the BBB 061 vintage [which] is w[h]ere almost [all of the] significant exposure rest[s] was approximately 24% during November, which relates to 2005 collateral.*** (Emphasis added).

197. If, as the Company admitted, a 24% decline in the ABX Index during November

guided Morgan to take an additional ***$4.1 billion write-down*** to its subprime-related positions, then a 32.8% drop in that same ABX Index during the Company's third quarter should similarly have resulted in a massive write-down on these positions.

198. Likewise, Morgan reiterated the fact that the ABX Index was the proper benchmark for valuing the CDS position during the fourth quarter of 2007, even though the subprime CDS markets were more distressed and illiquid in the fourth quarter than they were in the third quarter.

199. Indeed, unlike write-downs in Third Quarter 2007, the Company's belated total losses recognized for the six-months-ended November 30, 2007 closely tracked, on a percentage basis, the deterioration in the ABX.HE.BBB 06-1 during the same period, as can be determined by the Company's own disclosures of the total CDS position held by the Global Proprietary Group:

Reporting Period	**ABX Index BBB. 06-1 Decline**	**Morgan's Losses on the Proprietary Trading Group's CDS Position**
3Q 2007	32.8 %	$1.9 billion on a $13.2 billion notional position (14.4%)
4Q 2007	50%	$7.1 billion on a $13.2 billion notional position (62.3%)
3Q + 4Q 2007	65.1%	68.2%

200. The Company's total losses recognized on this CDS long position for the second half of 2007 of 68.2% exceeded the 65.1% decline in the ABX Index during the second half of 2007. Thus, while the Company avoided recognizing a net loss in the third quarter, it recorded a fourth quarter loss in the financial statements which exceeded the quarterly decline in the ABX as a "catch-up" in order to value the CDS positions at "fair value" as required by GAAP at year end.

201. As discussed below, Morgan's loss recorded in the fourth quarter was spurred by information leaked into the marketplace in the first days of November 2007, shortly after the Company fired Howie Hubler, the head of the Proprietary Trading Group on November 2, 2007. Within days of Hubler being fired, rumors began to circulate within the analyst ranks that Morgan

was poised to take a $3-$6 billion write-down related to previously undisclosed subprime disclosures. In effect, the Company, as discussed more fully below, was forced to come clean to its investors.

E. Morgan Has a Pattern of Abusing Fair Valuation Methodology to Manage Earnings

202. Morgan's manipulation of the fair value of its subprime assets and liabilities in the third quarter of 2007, to avoid taking a necessary write-down was not the first time Morgan deliberately overvalued its net assets and overstated its financial condition.

203. In 2004, the SEC imposed a cease-and-desist order against the Company pursuant to Section 21(c) of the Exchange Act, finding that the Company had overvalued certain high-yield bonds by failing to properly value the bonds as of the current measurement date.

204. Instead, the Company purportedly took a "longer view" as to their value, by discounting, or ignoring current market conditions. According to the SEC's Accounting and Auditing Enforcement Release No. 2132 dated November 4, 2004, Morgan believed the market conditions rendered third-party price quotations unreliable. And while GAAP required Morgan to use its best efforts to determine the fair value of the bonds, the Company valued them by "taking a longer view of the market" and essentially put its subjective opinion about the value of the bonds ahead of prices quoted by external pricing sources. By overvaluing those bonds, the SEC concluded that "Morgan Stanley's financial results for the fourth quarter of fiscal 2000, as reported on filings made with the Commission, were misstated and not in conformity with GAAP."

205. Similarly, the SEC also found that the Company overvalued certain aircraft leasing assets subsequent to the September 11, 2001 terrorist attacks. Morgan used a "base value" method that was not in compliance with GAAP to determine the value of certain impaired aircraft in its portfolio. As with the bond valuations, Morgan failed to consider the current market conditions to calculate fair value. As a result of overvaluing the aircraft assets, the SEC concluded that "Morgan Stanley's financial results for the fourth quarter of fiscal year 2001, third quarter of fiscal 2002 and the first quarter of fiscal 2003, as reported on filings made with the Commission, were misstated and not in conformity with GAAP."

F. A Known Breakdown of Morgan's Internal Risk Controls Contributed Significantly to the Company's Subprime Losses

206. As set forth above, as Mack's risk-enhanced business model was being implemented at Morgan, Defendants quelled analysts' and investors' fears by assuring them that the Company was assuming risk in a disciplined way and that all of its positions were being actively risk managed. These risk measures purportedly included frequent communication between risk managers, traders, and the Board of Directors' Audit Committee, as well as an elaborate set of limits and independent review processes for new products and valuation models.

207. In addition to these representations about Morgan's risk controls, the Company also represented to investors that it had internal control systems and valuation models in place to ensure the accuracy of its quarterly asset valuations. For example, as set forth above, the Company assured investors that "reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks" and that "groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate."

1. Contrary to the Company's Representations, Morgan's Risk Controls Were Wholly Deficient

208. As the subprime crisis unfolded, the Defendants pointed to Morgan's effective risk controls as having prevented the Company from taking on any catastrophic subprime risk. These representations were a complete fabrication.

209. On April 8, 2005, during Purcell's final days as CEO of the Company, *Forbes* reported that he promoted Thomas Daula to the position of Chief Risk Officer ("CRO"). According to the article, Daula reported directly to CEO Purcell.

210. However, unbeknownst to investors, shortly after taking control of the Company, Mack changed a vital aspect of the risk reporting structure, creating a fundamental flaw in the system that put the leadership structure of the Institutional Securities Group—those whose bonuses were dependent on ISG's performance—to assume ultimate responsibility for the Company's risk controls.

211. In October 2005, Mack, without any disclosure to investors, altered Daula's reporting line so that Daula reported directly to Cruz. However, Cruz, who "shared [Mack's] healthy appetite for risk," was also in charge of the Institutional Securities Group, and oversaw the Company's fixed income trading operations. This created an inherent undisclosed conflict of interest within the Company's risk management system, as the individual responsible for managing risk was now reporting directly to an individual who was compensated for taking on risk, a reporting structure that, in essence, placed the fox in charge of the proverbial henhouse.

212. This reporting structure was also particularly dangerous for the Company because Cruz's appointment as the head of the Institutional Securities Group -- a position she attained under Purcell in 2005 -- was extremely controversial among the traders within the Company, and her authority and ability was openly questioned and challenged.

213. In Cruz's very open battles with the former head of the Institutional Group, Vikram Pandit, while Cruz was head of Morgan's Fixed Income Group and Pandit's subordinate, Pandit reportedly told a colleague, in response to Cruz's concerns that the Company was not taking on more risk, "I'd be more than happy for Zoe to take on more risk, if I felt comfortable that she understood the risk she'd be taking." Joe Hagan, Only the Men Survive; The Crash of Zoe Cruz, *New York Magazine*, May 5, 2008. According to this same article, Cruz "was not taken at all seriously by her male colleagues: 'She'd give speeches, and the eyes would roll . . .' [and] the attitude towards attending meetings headed by Cruz was 'take the pain and move on.'"

214. When Purcell appointed Cruz co-president of the Company, above Pandit, and elevated her to director, in response to the insurrection from Pandit and other senior managers in the Institutional Securities Group, she was branded a traitor. When John Mack succeeded Purcell, and sought the return of executives, like Pandit, that had left ISG in protest over Purcell, reportedly Pandit and others demanded that Cruz be fired first.

215. In effect, Mack had placed risk management of ISG under the authority of the very person – Cruz – who stood to benefit most from the inflated valuations of the positions held by ISG.

216. Moreover, the risk reporting structure developed by Mack in 2005 violated

conventional wisdom on Wall Street, which long considered the best practice to be for the CRO to report directly to the CEO. For example, in a 2001 article, James Lam of Risk Management stated that, to the extent the CRO reports to the CFO or Treasurer, and is therefore two or three levels below the CEO, the CRO's function becomes increasingly less productive. Further, a 2004 *Bank Accounting and Finance* article stressed that the CRO must have full and continuing support of the board and the CEO, and must report directly to the head of the corporation. Likewise, according to a senior credit officer and risk management specialist at Moody's Investors Service, "Moody's regards as best practice the appointment of a chief risk officer who reports directly to the chief executive officer and to the board." Even having the CRO report to the CFO would have been more standard practice than having the CRO report to Cruz, because at least the CFO is independent of the business division whose positions the CRO is supposed to evaluate.

217. Despite deviating significantly from the original reporting structure, which was considered best practice in the industry, the Company did not publicly disclose that Daula would begin reporting to Cruz in October 2005. Instead, throughout the Class Period, investors were led to believe that Daula was reporting directly to Mack. It was not until two years later, after recording $9.4 billion in mortgage-related write-downs, that Defendants publicly acknowledged the falsity of statements relating to the undisclosed change in reporting structure. The Company further confirmed that the reporting change was made in October of 2005 and that while the Audit Committee did not formally review the change, its members were aware of it.

218. Although contradicting accounts of Class Period events have been proffered by the individuals involved, both versions of these contradictory stories make clear that risk control function at Morgan had completely broken down, rendering Defendants' Class Period reliable representations about the risks to which Morgan was exposed materially false and misleading. It is also clear from these accounts that Mack's undisclosed change to the risk reporting structure contributed significantly to the Company's risk management system's breakdown during the subprime mortgage crisis in 2007.

219. According to a December 21, 2007 article appearing in the *Financial Times*, due to the altered reporting structure, Daula would brief Cruz weekly on the Company's risk position.

According to this account of events, Daula understood the activities of the structured products traders well, and by August of 2007, he claims to have vocalized his concerns about their activities. Specifically, he warned executives that there were "no proper pricing models for such trades, that positions were not being properly measured, and that the history traders used in their models was not a reliable guide." Further, the *Wall Street Journal* reported that once concerns were raised internally regarding the Company's potential subprime-related losses, Defendant Mack began personally attending the weekly risk assessment meetings as well.

220. The May 5, 2008 article appearing in *New York Magazine* paints a starkly different portrait of the events culminating in Morgan's $9.4 billion mortgage-related write-down. According to this account, Cruz became extremely concerned about the mortgage market beginning in May 2007 after a random encounter with a real estate executive in California. Upon returning, Cruz began attempting to extricate the Company from many mortgage-related positions, and asked Daula to assess the Proprietary Trading Group's risk of loss in the event of a mortgage market meltdown. When Daula told Cruz one month later, over the July 4th holiday, that Morgan could lose approximately $3.5 billion under such circumstances, Cruz claims to have directed Daula and Shear to "[c]ut the position." According to the article, Shear and Daula deny receiving that order, while Cruz's allies contend that Daula and Shear "deferred to Howie [Hubler] instead of listening to Zoe." By the time Shear and Daula purportedly heeded Cruz's advice, the article states that the market had fallen and the Company could only unwind $1.8 billion of the position.

221. Despite the discrepancies in these accounts, it is evident that from very early on or even prior to the beginning of the Class Period, both Daula and Cruz had direct knowledge of the risks associated with the Proprietary Trading Group's extremely risky trading strategy, that these risks were correlated to movements in the markets for subprime securities, and that none of this information had been disclosed to the market. Nevertheless, the Proprietary Trading Group's toxic mortgage-related position remained concealed on the Company's books until long after the mortgage market had begun its free fall.

222. What is also clear from both of these accounts is that the Company's massive exposure as a result of the Proprietary Trading Group's position and the Company's risk failures

were known to all of Morgan's senior executives by no later than July 2007 and, as alleged above, were knowingly concealed from investors.

223. Defendants' knowledge and appreciation of the risks associated with the Proprietary Trading Group's CDS positions is further corroborated by CW 4, a senior level employee within the Company's Fixed Income division. CW 4 stated that during the summer of 2007, Anthony Tufariello, the Global Head of the Securitized Products Group, and immediate supervisor of Howard Hubler, convened a meeting of forty to fifty key, senior employees in the Fixed Income Division. Tufariello told the meeting participants that the meeting was convened at the explicit direction of Zoe Cruz. According to CW 4, Tufariello informed the meeting participants, whom he referred to collectively as a "super task force," that Morgan had a "large position" with exposure to the subprime mortgage market, and that there was a need to develop "creative strategies" to sell the "assets at risk." CW 4 recalled that during the meeting, the discussion of the assets at risk included references to CDSs, super senior CDO tranches and subprime mortgages.

224. According to CW 4 shortly after this meeting, a senior member of the Company's structuring and modeling group instructed Michael Jensen, a trader who worked in the Proprietary Trading Group, to meet with a fixed income securities analyst to assess the Proprietary Trading Group's subprime position. Specifically, CW4 believes the individuals were tasked with determining the "range of how bad things could get." According to CW4, he was told that this weeklong assessment of the potential downside risk to the Company was prepared for Defendants Cruz and Mack as part of a larger report analyzing the Proprietary Trading Group's positions.

2. <u>The Company's Risk Control Failures Were Compounded By Known Deficiencies in the Company's Ability to Value Its Positions</u>

225. Throughout the Class Period, the Company represented to investors that it had internal control systems and valuation models in place to ensure the accuracy of its quarterly asset valuations. For example, as set forth above, the Company assured investors that "reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks" and that "groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the

review and validation of the fair values generated from pricing models, as appropriate."

226. Notwithstanding these representations, significant internal control deficiencies existed within the Company's valuation department during the Class Period, causing executives like CRO Daula to question the Company's ability to accurately value its mortgage-related positions. As reported by the *Financial Times*, individuals familiar with the Company stated that by August of 2007, Daula "was very vocal in saying that there were no proper pricing models for [the Hubler] trades, that positions were not being properly measured, and that the history traders used in their models was not a reliable guide."

VIII. DEFENDANTS' MATERIALLY UNTRUE STATEMENTS AND OMISSIONS

A. Morgan Stanley Reports a Blockbuster Beginning to Fiscal 2007 in Pre-Class Period Statements that Impacted the Total Mix of Information During the Class Period

227. Morgan entered into the Second Quarter of fiscal 2007 (March 2007 through May 2007) with reported "record results across the board." These results included record revenues, net income and EPS for First Quarter of fiscal 2007, which largely had outperformed expectations owing to what Defendants described as "disciplined and balanced" increased risk taking and strong trading performance. Significantly, Defendant Sidwell reported $3 billion in profit attributed to record net revenues of $7.6 billion in Institutional Securities and that fixed income sales and trading had contributed $3.6 billion in revenues, which he stated was the Company's best quarter ever and was owed in large part to results from Morgan's credit products area and favorable positioning in the sub-prime mortgage markets from an increase in securitized products.

228. At a time when the subprime loan market was collapsing, Defendants knowingly and recklessly presented Morgan as impervious to the growing crisis. Morgan reported record profits from Defendants' self-described well-balanced risks. While reporting earnings for First Quarter 2007, Defendant Sidwell expressly acknowledged that subprime had been a key focus in the market during early March 2007, and he stated that the Company managed its risk through a variety of hedging strategies and proprietary risk positions that had significantly contributed to Morgan's record results. Defendant Sidwell further reported that the Company had decreased risk exposure

during the latter part of the First Quarter 2007 to balance Morgan's level of risk with Defendants' view of potential market changes. In response to analysts' questions, Sidwell acknowledged that its acquisition of Saxon and increased participation in mortgage origination had provided key insights into understanding where investment opportunities were and where the markets were heading.

229. On April 11, 2007, Deutsche Bank initiated coverage on Morgan with a "Buy" rating and a 12-month price target of $101 per share. Analysts at Deutsche Bank noted that Morgan had taken more risk with trading and principal investments, while also stating that the Company was not "betting the bank" with its investments. The Deutsche Bank analysts reported that Morgan was "hedged properly" during difficulties in the subprime segment in February 2007. The research report further that Morgan's higher level of risk needed to be monitored and emphasized that the Company's CEO had emphasized "taking additional risk when there is a reasonable return." The analysts also reported that Morgan's head of risk management sat on the Company's management committee.

230. Analysts at Deutsche Bank issued a research report on May 10, 2007, following their meeting the same day with CEO, defendant Mack. Reiterating their "Buy" rating on Morgan, the analysts reported that factors driving the Company's growth included "better capital allocation/optimization of the balance sheet" as mandated by the CFO, and "more principal activity" with a "gradual[] increase" in the amount of trading risk. The research report further stated that Morgan was looking to increase the degree of principal risk taking to try to bridge the gap in the Company's performance, which lagged behind "best-in-class Goldman Sachs."

B. At the Beginning of the Class Period Defendants Continue to Report Record Earnings for Morgan Stanley in Second Quarter 2007

231. At the beginning of the Class Period, on June 20, 2007, Morgan issued a press release and reported its financial results for Second Quarter of fiscal 2007 (March 2007 through May 2007). Defendants again reported record income from continuing operations of $2.6 billion for the three months ended May 31, 2007, which was an increase of 41% from the second quarter of 2006. Morgan also reported record net revenues of $11.5 billion for its fiscal Second Quarter 2007, which was an increase of 32% from the second quarter of 2006. The Company also reported record

net revenues of $7.4 billion for its Institutional Securities Group, which was a 39% increase over second quarter 2006, and record pretax income in the amount of $3 billion.

232. For the six months ended May 31, 2007, Defendants reported record income from continuing operations of $5.1 billion, which was a 50% increase from the same period in 2006. Net revenues for the six-month period ended May 31, 2007 were reported as a record $22.5 billion. Institutional Securities reportedly contributed $5.8 billion of the Company's pre-tax income and $14.5 billion of its net revenues for the six months ended May 31, 2007.

233. Morgan also reported that fixed income sales and trading revenues increased 34 percent to $2.9 billion, which the earnings release touted was "the second-best quarter ever in this business." The Company attributed increases in income from fixed income sales and trading to strong results from credit products, with trading revenues driven by corporate credit and structured products, although it reported "lower securitized products revenues, primarily in residential mortgage securities."

234. In the earnings release, Defendant Mack stated that "Morgan Stanley delivered record revenues and earnings in the second quarter and first half of the year" and he further emphasized that the Company was well on their way to "reaching [its] goal of doubling 2005 earnings over five years." Mack never disclosed that known trends and uncertainties surrounding and arising from the subprime crisis, and specifically the Company's CDS positions entered into by the Proprietary Trading Group, were quickly reversing from favorable positions that had significantly contributed to the Company's record reported results for the first half of fiscal 2007. Defendant Mack and others ignored current market conditions, including the fact that the ABX Index benchmark used by Morgan to value its CDS positions had declined 12% by the time Defendants reported results for fiscal Second Quarter 2007, and they failed to disclose that the Company faced material risks and losses relating to the subprime crisis and its $13.2 billion long CDS position.

235. During the Second Quarter 2007 earnings conference call held on June 20, 2007, Defendant Sidwell made statements regarding Morgan's positions in the subprime mortgage market. Sidwell opened the call by claiming that "concerns early in the quarter about whether

issues in the sub prime market were going to spread dissipated." He also emphasized that the record results achieved in Second Quarter 2007 reflected the execution of Defendants' "strategic growth plans and strong trading performance." After reporting record income from continuing operations of $2.6 billion and record EPS of $2.45 for Second Quarter 2007, Sidwell emphasized Morgan's reported results for the Institutional Securities business segment and stated that the "strength and diversity of our franchise was evident in the quarter."

236. Defendant Sidwell further stated on the Second Quarter 2007 earnings conference call that results from credit products had declined 24% from First Quarter 2007, which had included "record securitized products revenues driven by favorable positioning in the sub prime mortgage market." An analyst from Lehman Brothers specifically asked Defendant Sidwell whether the Company's favorable hedging position in the mortgage area from First Quarter 2007 could be compared or characterized for Second Quarter 2007, and whether the Company was "down just more as a function of sort of a decline in activity in the market in some marks or was there sort of negative positioning, i.e., betting the wrong way?" Sidwell responded vaguely that Morgan had really benefitted from market conditions in subprime in First Quarter 2007 and "spreads didn't really move a whole lot during the second quarter, so there were lower opportunities" and "we certainly did not lose money in this business."

237. On June 20, 2007, Deutsche Bank issued a research report, with analysts reiterating their "Buy" rating and reporting that Morgan's reported Second Quarter 2007 EPS of $2.45 per share was above the consensus of $2.01 due, among other things, to "record institutional securities."

238. During the three-month period from when Morgan reported its First Quarter 2007 earnings results in March 2007 and when it reported its Second Quarter 2007 results in June 2007, the Company's stock price increased approximately 16% from a close of $75.02 per share on March 19, 2007, to a close of $87.32 per share on June 20, 2007.

239. On June 21, 2007, analysts at KBW issued a research report on Morgan, reporting that the Company has strong Second Quarter 2007 results and EPS well ahead of the analysts' estimate. The report also stated that the Company's Institutional Securities Group was an "out performer" and focused on reported net revenues of a "record" $11.5 billion, which "handily" beat

analysts' estimates of $9.5 billion and had risen 32% from the same period in 2006. The analysts noted that fixed income sales and trading were down 16% for the quarter compared to first quarter 2007, but that they were up 34% year-over-year. Based on the Company's reported Second Quarter performance, the KBW analysts raised 2007 earnings estimates for Morgan from $8.15 to $8.79 "given the stronger than expected results" and reiterated its "Outperform" rating, which is their highest core rating. The analysts also noted favorably that Morgan's reported results were excellent relative to the reported performance of its peer companies such as Lehman Brothers, Goldman Sachs and Bear Stearns.

240. Defendants' statements and reported results for the quarter and six months ended May 31, 2007, were materially false and misleading when made and omitted to disclose material facts necessary to make the statements made not misleading because they failed to disclose the following materially adverse facts that Defendants knew and deliberately and recklessly disregarded:

(a) The ABX Index for BBB.06-1 was the standard benchmark, and was used by Morgan Stanley to value its CDS positions, and this index had declined approximately 12% between December 2006 and June 20, 2007;

(b) Defendants were aware from their acquisition of Saxon and increased participation in mortgage origination and participation in the market that the subprime market had deteriorated substantially in Second Quarter 2007 as mortgage companies filed for bankruptcy protection and reported significant losses as a result of increasing borrower defaults, and mortgage foreclosures had risen and were continuing to rise and home prices were falling;

(c) Defendants were aware that liquidity in the CDO market had tightened and that risks of catastrophic material losses arising from the Proprietary Trading Group's long CDS position had increased and likely would materialize;

(d) RMBS related to subprime borrowers had experienced significant downgrades from the Ratings Agencies, and rising defaults had triggered repurchase obligations in agreements used to create RMBS;

(e) Defendants had failed to implement adequate internal controls and risk management for its proprietary trading;

(f) Defendant Sidwell failed to disclose the Company's subprime exposure and falsely implied that Morgan Stanley would continue to profit from any additional declines in the value of subprime mortgages; and

(g) Defendants failed to disclose that Morgan Stanley had in fact "bet the wrong way" on its subprime CDS position and was no longer favorably positioned, but instead stood to lose billions of dollars from a single trading strategy that could and ultimately did wipe out a material percentage of the Company's annual income.

241. On June 30, 2007, Morgan effected its previously-announced spin-off of its Discover Financial business, which caused analysts to reassess earnings estimates for the post-spin-off $5.4 billion reduction to the Company's book value. Deutsche Bank analysts estimated that Morgan Stanley's shares would trade at approximately $69 per share, and they lowered estimated 2007 EPS from $8.52 to $8.39. On July 2, 2007, Morgan Stanley's stock closed at $71.33, which was higher than analysts had estimated for the Company, excluding Discover Financial.

242. On July 10, 2007 Morgan filed its Form 10-Q with the SEC for Second Quarter 2007. In the Company's Form 10-Q for Second Quarter 2007, Defendants repeated the record financial results reported in Morgan Stanley's earnings release and further delineated the value of the Company's assets, including derivative contracts, which were stated at $56.5 billion, and corporate and other debt, which was stated at $167.8 billion.

243. Defendant Sidwell signed, and Defendants Mack and Sidwell certified, the Second Quarter Form 10-Q as required under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). Defendants Mack and Sidwell each certified that the Company's SEC filings did not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading. They further certified that the financial statements, and other financial information included in the SEC filings, fairly presented in all material respects the financial condition, results of operations and cash flows of the Company. The statements contained in both Mack and Sidwell's certifications were materially false and misleading when made because they failed to disclose materially adverse facts relating to the Company's growing catastrophic subprime exposure and related lack of appropriate and necessary risk controls, which were known to Defendants Mack, Sidwell and Cruz and recklessly disregarded by them.

244. While the Wall Street investment banks and companies with exposure to the mounting subprime crisis watched their stock prices fall precipitously, Morgan Stanley's stock price held steady at $70.46 on July 10, 2007, and ticked up to $72.40 on July 12, 2007, in response to the

Company's positive reports.

245. KBW analysts further reported based on information released in the Company's Second Quarter 2007 10-Q that Morgan Stanley's results have "reflected a constructive operating environment" and that it had the "right leadership to make investments" and that the Company's "results over the past few quarters are crystal clear validation of the successful turnaround story at Morgan Stanley." As a discrete mark of success, the analysts emphasized that the Company's ROE in institutional securities had increased to 34% in the first half of fiscal 2007, as compared to 22% in 2004 and 31% in 2006. They further reported that the Company was well able to manage the increased risk from more principal activities.

246. In the Form 10-Q for Second Quarter 2007 and continuing throughout the Class Period, Defendants repeatedly represented that financial instruments used in trading were recorded at "fair value" and that a substantial percentage of the fair value of the Company's financial instruments used for trading were based on "observable market prices, observable market parameters, or is derived from such prices or parameters." The Company also reported that it had adopted SFAS No. 157 on December 1, 2006, and that its assets and liabilities recorded at fair value "have been categorized based upon a fair value hierarchy in accordance with SFAS No. 157."

247. Additionally, the Form 10-Q for the Second Quarter 2007 incorporated language from the Company's 2006 10-K which stated that "Company Control Groups...are all independent of the Company's business units."

248. Moreover, in the Form 10-Q for Second Quarter 2007, Defendants falsely represented material risks in Morgan Stanley's management and risk reporting structure and related internal controls. In the Second Quarter 10-Q, the Company disclosed its control processes for fairly valuing assets as required by GAAP as follows:

> ***Fair Value Control Processes***. The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable market prices or market-based parameters wherever possible. In the event that market prices or parameters are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and consistently applied and that the assumptions are reasonable. These control processes

> include reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks. Additionally, **groups independent from the trading divisions within the Financial Control and Market Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate**. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model. (Emphasis added).

249. Defendants' statements regarding the Morgan Stanley's risk controls and processes were materially false and misleading when made and omitted to disclose material facts necessary to make the statements made not misleading because, as Defendant Mack admitted on December 19, 2007, the Company was negligent in implementing internal controls as appropriate and necessary to manage the increased level of risk Defendants had knowingly and deliberately created. Following the announcement of the Company's staggering $9.4 billion in write-downs, Defendant Mack admitted that, in conducting stress analyses of the Company's subprime positions, it is "fair to say that our risk management division did not stress those losses well."

250. Morgan Stanley's internal controls and risk management were not what the Company purported them to be as Mack admitted in the Company's December 19, 2007 earnings call "in the past, the way it was run that risk monitoring and risk management reported in to the President of ISG [Institutional Securities Group]…I think the right reporting line is not to the business unit head or the division head, but someone totally independent who reports directly to me…."

251. Zoe Cruz was the President of Morgan Stanley's Institutional Securities Group, and, therefore, she controlled risk monitoring and risk management with respect to the Company's Institutional Securities trading, and specifically its CDS positions. At least by early July 2007, Cruz was aware that market influences impacting the Company's CDS positions had materially deteriorated and that Morgan Stanley stood to lose billion of dollars as a result of the Proprietary Trading Group's "guess the wrong way" on the CDS trade he had executed in late 2006.

252. Defendants' statements and reported results for the quarter and six months ended May 31, 2007, as set forth in the Second Quarter 2007 From 10-Q were materially false and

misleading when made and omitted to disclose material facts necessary to make the statements made not misleading because they failed to disclose materially adverse facts that Defendants knew and deliberately and recklessly disregarded as set forth above in ¶ 240. Defendants' statements further were materially false and misleading because they knowingly and recklessly failed to disclose the Company's massive subprime exposure and the deteriorating subprime market and further decline in the ABX Index, which had declined approximately 17% between December 2006 and July 10, 2007 when the Second Quarter 2007 Form 10-Q was filed.

C. Defendants Manipulate Morgan Stanley's Reported Financial Results for Third Quarter 2007

253. On September 19, 2007, Morgan Stanley reported its financial results for Third Quarter of fiscal 2007 (June 2007 through August 2007). Defendants held an earnings conference the same day and reported income from continuing operations of $1.5 billion for the three months ended August 31, 2007, which was a decrease of 7% from the third quarter of 2006, and EPS from continuing operations of $1.38. Morgan Stanley also reported net revenues of $8.0 billion for its fiscal Third Quarter 2007, which was an increase of 13% from the third quarter of 2006. The Company also reported net revenues of $5.0 billion for its Institutional Securities Group, which was a 2% increase over third quarter 2006, although "down from the record second quarter." Pretax income for the Institutional Securities Group in Third Quarter 2007 was reported at $1.5 billion, which was down 22% from third quarter 2006.

254. In addition, Morgan Stanley reported that fixed income sales and trading revenues in the amount of $2.2 billion had decreased 3 percent from third quarter 2006. The Company attributed the decrease to "significantly lower credit revenues as spread widening, lower liquidity and higher volatility resulted in lower origination, securitization and trading results across most products."

255. For the first nine months of fiscal 2007, Morgan Stanley reported income from continuing operations of $6.2 billion, which was a 41% increase over the same period in 2006. Defendants reported EPS from continuing operations at a record $5.79 and net revenues of a record $28.5 billion, which was a 29% increase over the same period in 2006.

256. In the earnings release, Defendant Mack stated that "Morgan Stanley's

diversification across businesses and regions helped us deliver ROE of 17.2% this quarter, despite the impact of the severe market disruption on some areas of the Firm....Even with these turbulent markets, Morgan Stanley still delivered strong performances across many core businesses....In addition, we continued making progress in executing our growth plans....As always, the people of Morgan Stanley remain intensely focused on helping our clients navigate the constantly changing markets and seizing the opportunities they offer our clients and the Firm. In the months ahead, we will continue to leverage our diverse, global franchise to create value for our clients and shareholders."

257. On the earnings conference call for Third Quarter 2007, Defendant Sidwell falsely stated that "[t]he disclosure provides our assets and liabilities that are recorded at fair value." Defendant Kelleher also falsely stated that "our risk measurement systems performed very well." During the call Sidwell also stated that "our valuation models are calibrated to the market on a frequent basis. The parameters and inputs are adjusted for assumptions about risk, and in all cases if market data exists, that data will be used to price the assets or liabilities. The valuation of these instruments are reviewed by an independent valuation group outside of the business units, and subject to the scrutiny of our auditors. So we are confident that we have appropriately valued these positions."

258. In the third quarter earnings release and the September 19, conference call, Defendants deliberately and recklessly failed to disclose that Morgan Stanley's assets and liabilities related to its CDS positions were not recorded at fair value as required by GAAP. By overstating the Company's assets and understating liabilities, Defendants also knowingly and recklessly overstated Morgan Stanley's income and EPS. By continuing to report gains from its bearish subprime CDO bet and failing to report losses from its bet the wrong way on its $13.2 billion long CDS position, Defendants knowingly and recklessly presented an overall impression that was not consistent with the business realities of the Company's financial position and operations.

259. By the end of its Third Quarter 2007, Defendants knew and deliberately and recklessly failed to disclose that Morgan Stanley was facing cataclysmic losses on its CDS positions, which Zoe Cruz, according to her own account, had unsuccessfully ordered the

Proprietary Trading Group to eliminate in July 2007.

260. Defendants knew and deliberately disregarded that the proper way to measure the fair value of the Company's CDS positions was by reference to a key ABX index benchmark (BBB 06-1) and other ABX indices that Defendants had been using to value the Company's CDS positions since the Proprietary Trading Group's initial trade. During Morgan Stanley's fiscal Third Quarter 2007, the BBB 06-1 index reflected a 32.8% decline (from 94.5 on May 31, 2007; to 63.5 on August 31, 2007).

261. Without any related disclosures, Defendants knowingly and recklessly failed to record losses on Morgan Stanley's CDS positions commensurate with the decline in their benchmark ABX index as required to state the assets and liabilities at fair value in accordance with GAAP. Defendants should have recorded losses on Morgan Stanley's $13.2 billion CDS long position by 32.8%, which amounts to a $4.4 billion loss on this position, at the end of fiscal Third Quarter 2007.

262. Defendants failed to fully recognize this loss in the Third Quarter of 2007, as required by GAAP. Instead, Defendants deliberately manipulated Morgan Stanley's financial statements by understating the losses on its CDS positions by $2.5 billion, recognizing only $1.9 billion of the $4.4 billion loss on the CDS long position. Defendants also recognized $1.1 billion in losses on other subprime-related ABS CDO bond positions for the fiscal Third Quarter 2007, but they deliberately did not disclose the nature or total gross amount ($3.0 billion) of recognized subprime losses, or that Morgan Stanley had additional, potentially catastrophic, exposure to subprime losses until November 7, 2007. Because of Defendants' failure to record losses on Morgan's CDS positions to reflect their fair value at the end of Third Quarter 2007, the Company's assets, trading revenue, income and earnings were materially overstated and liabilities understated, and its risk and exposure to the unprecedented subprime crisis were knowingly concealed. The additional recorded losses on the $13.2 billion CDS position, if recognized, would have caused Morgan Stanley to report a pre-tax loss of approximately ($300 million), instead of the falsely reported pre-tax income of $2.3 billion for fiscal Third Quarter 2007.

263. As set forth above, in the Third Quarter 2007, the Company reported EPS of $1.38

per share, in line with the low end of analysts' projections. However, the Company failed the meet the consensus estimate of $1.54 EPS per share. On news of the Company's earnings and Third Quarter 2007 performance, Morgan Stanley's stock price closed on September 19, 2007 at $67.03, which was slightly down from the prior day's close of $68.51.

264. During the September 19, 2007, conference call, Kelleher stated "we remain exposed to risk exposures through a number of instruments [including] CDOs. . . We believe it will take at least a quarter or two for the credit markets to return to a more normal extension of credit and provision liquidity. . . ." He then added "we believe turbulent times like this are an opportunity for Morgan Stanley to distinguish itself and outpace our peers."

265. What Defendants failed to disclose is that Morgan Stanley had distinguished itself from its Wall Street peers because Defendants had cooked the Company's books. By quietly ignoring significant observable Level 2 inputs and using subjective unobservable Level 3 inputs, Defendants improperly disassociated the value of the Company's $13.2 billion long CDS position from the decline in the ABX Index, and Morgan Stanley fraudulently avoided recognition of at least $2.5 billion of losses in Third Quarter 2007. Regarding the shift from Level 2 to Level 3 inputs, Defendant Sidwell, during the earnings conference call, stated only that "Given the third quarter market dynamics, more instruments have become illiquid, and as you expect, the level of financial assets categorized in Level 3, which is the most illiquid category, have increased." He failed to report that use of these inputs to value the assets and liabilities related to the CDS position was a mechanism employed by Defendants to avoid recording them at fair value as required by GAAP.

266. Defendants' statements and reported results for the Third Quarter and first nine months ended August 31, 2007, were materially false and misleading when made and omitted to disclose material facts necessary to make the statements made not misleading because they failed to disclose the following materially adverse facts that Defendants knew and deliberately and recklessly disregarded:

(a) The ABX Index for BBB.06-1 was the benchmark used by Morgan Stanley to value its CDS positions, and this index had declined 32.8% during Third Quarter 2007;

(b) Defendants were aware from their acquisition of Saxon and increased participation in mortgage origination and participation in the market that the subprime market had deteriorated substantially in Third Quarter 2007 as the Ratings Agencies substantially and dramatically downgraded RMBS and ABS CDOs as mortgage companies and mortgage insurers had filed for bankruptcy protection or ceased paying and borrower defaults and mortgage foreclosures continued to rise to epidemic levels;

(c) Defendants were aware that liquidity in the CDO market had tightened and that risks of catastrophic material losses arising from the Proprietary Trading Group's $13.2 billion long CDS position had increased and likely would materialize;

(d) RMBS related to subprime borrowers had experienced significant downgrades from the Ratings Agencies, and rising defaults had triggered repurchase obligations in agreements used to create RMBS;

(e) Defendants had failed to implement adequate internal controls and risk management for its proprietary trading, and Morgan Stanley's risk measurement systems had not performed well;

(f) Defendants Sidwell and Kelleher failed to disclose the Company's subprime exposure and falsely implied that Morgan Stanley would continue to profit from any additional declines in the value of subprime mortgages;

(g) Defendants failed to disclose that the Company was no longer favorably positioned, but instead stood to lose billions of dollars from a single trading strategy that could and ultimately did wipe out a material percentage of the Company's annual income; and

(h) Morgan Stanley's CDS positions were not recorded at fair value, and Defendants subjectively valued the CDS positions using Level 3 inputs and ignored observable Level 2 inputs to manipulate the Company's reported financial results and overstate income by $2.5 billion.

267. On October 10, 2007, Morgan Stanley filed with the SEC its quarterly report on Form 10-Q for Third Quarter 2007. In the financial statements reported in this Form 10-Q, Defendants failed to properly record and report losses on the Company's CDS positions as required to state them at fair value in accordance with GAAP. In the Form 10-Q, Defendants falsely indicated that "[t]he Company's financial instruments owned and financial instruments sold, not yet purchased are recorded at fair value."

268. Because Defendants knowingly and recklessly failed to record losses on Morgan Stanley's CDS positions to fair value in the Third Quarter as required by GAAP, the Form 10-Q overstates the Company's assets, trading revenues, net revenue, net income and income from the Institutional Securities business segment for Third Quarter 2007 and understates the Company's liabilities. Defendants deliberately manipulated Morgan Stanley's financial statements and shifted from Level 2 inputs to Level 3 inputs in valuing the CDS positions to overstate the value of these

positions by at least $2.5 billion. As a result, the Company reported income of $2.3 billion for the quarter, instead of the actual ($300 million) loss.

269. Defendants not only concealed Morgan's unrecognized losses from its CDS positions, but also they concealed the nature of the Company's recognized losses, as well as Morgan Stanley's substantial exposure to the unprecedented subprime crisis.

> In the Form 10-Q, the Company expressly reported that its financial statements are prepared in accordance with GAAP and stated that the "Company believes that the estimates utilized in the preparation of the condensed consolidated financial statements are prudent and reasonable." Defendants also made extensive "Fair Value Disclosures" and reported that the Company had adopted SFAS 157, which requires the Company's assets and liabilities to be "measured at fair value." The Company also described the "framework" for measuring fair value and how its assets and liabilities "recorded at fair value have been categorized based upon the fair value hierarchy in accordance with SFAS No. 157."

270. Defendants failed to disclose that they had deliberately ignored observable inputs for the CDS positions. It also was unclear from Morgan Stanley's disclosures that the Company had undertaken an excessive amount of risk from its subprime mortgage-related exposures. The Form 10-Q had scant references to its subprime-related exposure and failed to reflect that the Company recognized $3.0 billion in losses on its subprime-related CDS positions during Third Quarter 2007. Moreover, Defendants further failed to disclose that Morgan Stanley's proprietary trading desk had employed a subprime-related speculative trading strategy that exposed the Company to $10.4 billion in potential losses.

271. Under Regulation S-K, Morgan's Management Discussion and Analysis ("MD&A") was required to include a disclosure about "known trends or uncertainties" reasonably expected to have a materially unfavorable impact on income from continuing operations. At least by August 2007, Defendants were unable to reduce Morgan Stanley's subprime CDO-related exposure. As of August 31, 2007, the ABX.HE.BBB 06-1 had declined to 63.50, and by the time the Company filed its Form 10-Q on October 10, 2007, this index had dropped to 61.00. In the Form 10-Q, the Company should have disclosed that a write-down was necessary in the Third Quarter because of the dramatic downward turn in the value of the CDS positions as reflected by the decline in the ABX index, as well as market limitations on Defendants' ability to eliminate the subprime CDO-

related positions.

272. The limited references to the word "subprime" were buried in the Company's MD&A disclosures. Notwithstanding the SEC's request on August 30, 2007, for Morgan Stanley to provide more clarity regarding the Company's subprime exposure, Defendants limited their disclosures to general market conditions, as follows:

> Total sales and trading revenues decreased 16% in the quarter ended August 31, 2007 from the comparable period of fiscal 2006. Sales and trading revenues were adversely affected by the difficult market conditions that existed during the quarter ended August 31, 2007. The credit markets deteriorated considerably over the course of the quarter with increased volatility, significant spread widening, lower levels of liquidity and reduced price transparency. These factors affected the leveraged lending markets, the effectiveness of hedging strategies, **subprime** mortgage markets, including the market for collateralized debt obligations, and other structured credit product markets. This credit environment significantly impacted the Company's corporate lending and credit sales and trading activities. In addition, such conditions contributed to increased volatility and deleveraging in the equity markets, which affected the Company's quantitative trading strategies. (emphasis added).

273. Defendants Mack and Sidwell certified the Company's financial statements and internal controls as required by the Sarbanes-Oxley Act of 2002, falsely representing, as follows:

> this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report; 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report...

274. The Form 10-Q for the Third Quarter 2007 also contained false statements regarding the independence of the Company's control groups from its business segments as set forth above in ¶¶ 247 and 248.

275. The Form 10-Q for Third Quarter 2007 also falsely stated in relevant part that "disclosure controls and procedures were effective as of the end of the period covered by this report." This statement was materially false and misleading because Morgan Stanley's disclosure controls and procedures were not effective, and investors and shareholders could not have gleaned from any reported information that the Defendants had engaged in ineffective risk controls that caused $5.5 billion in recognized and unrecognized losses and created $10.4 billion in subprime-

related exposures from undisclosed high-risk CDS positions.

276. In the Third Quarter 2007 Form 10-Q, Defendants also disclosed that access to "global sources of financing" was imperative to Morgan Stanley's ability to conduct business because the Company relied on "external sources to finance a significant portion of its day-to-day operations." The Company reported that the "cost and availability of unsecured financings generally are dependent on the Company's short-term and long-term credit ratings." After reporting that a one-notch downgrade by Moody's or S&P would trigger obligations to deliver $588 million in additional collateral to counterparties, Defendants emphasized in that in Third Quarter 2007, "[o]n July 30, 2007, Standard & Poor's upgraded the Company's commercial paper rating from A1+ and upgraded the Company's Senior debt rating from A+ to AA-." Defendants never reported that downgrades were imminent or that S&P and Moody's had downgraded numerous sub-prime RMBS and ABS CDOs during Third Quarter 2007, which Defendants knew or recklessly disregarded because Morgan Stanley's research analysts had issued a report on the downgrades in the CDO markets on July 16, 2007.

277. Defendants' statements and reported results in the Form 10-Q for Third Quarter and first nine months ended August 31, 2007, were further materially false and misleading when made and omitted to disclose material facts necessary to make the statements made not misleading because they failed to disclose the following materially adverse facts that Defendants knew and deliberately and recklessly disregarded as set forth above in ¶¶ 258-262 and 265-266.

278. Defendants' materially false and misleading statements and omissions in Morgan's Third Quarter 2007 Form 10-Q are further demonstrated by Defendant Kelleher's February 1, 2008 letter to the SEC explaining the valuation of the Company's subprime positions. As part of the SEC's ongoing inquiry into Morgan's subprime exposure and related disclosures, on January 3, 2008, the SEC requested additional information from Defendants regarding the MD&A disclosures in the Third Quarter 2007 10-Q, as follows:

> We note in your Form 10–Q for August 31, 2007 you disclose in the MD&A that the US economy was experiencing signs of slowing during the third quarter 2007, primarily reflecting difficult conditions in the residential real estate and credit markets and that concerns about the impact of subprime loans caused the broader

> credit markets to deteriorate considerably over the quarter. In light of the economic slowing in the residential real estate and credit markets and your impairment of trading portfolio that included real estate securities, tell us how you determined that there were no decreases in fair value of your US subprime related balance sheet exposures during the third quarter 2007.

279. In Kelleher's response to the SEC, he stated the following:

> The Company's primary exposure to the U.S. subprime market is associated with "super senior" credit default swaps that reference synthetic asset backed security ("ABS") collateralized debt obligations ("CDOs") that themselves hold or are referenced to "mezzanine" collateral with ratings of BBB+, BBB, or BBB–....One of the key proxies for the move in the fair value of the Company's super senior credit default swaps is the ABX BBB index....During the third quarter of 2007, the ABX BBB indices, on average, declined by 50%.

280. Kelleher admitted that Defendants' relevant benchmark ABX indices for the $13.2 billion long CDS position had declined, on average, by **50%**, which further demonstrates that Defendants knowingly and recklessly ignored the "key proxies" for valuing this CDS position and reduced it by a mere 14% to manipulate Morgan's reported financial results for Third Quarter 2007. If Defendants had properly valued the $13.2 long CDS at fair value and recorded losses commensurate with the decline in the ABX indices, then the Company would have recorded at least ($2.5 billion) more in losses in Third Quarter 2007, which were not offset by gains on other U.S. subprime positions as Kelleher erroneously indicated to the SEC.

IX. PARTIAL DISCLOSURES AND ADDITIONAL FALSE STATEMENTS

281. Amid the flurry of subprime write-downs by competing investment banks, Morgan Stanley presented itself as a Company that had deftly maneuvered through the subprime crisis and made the right bets, *i.e.*, against subprime. These representations had allowed Morgan, as against its peer Wall Street banks, to secure higher credit ratings, including ratings upgrades on July 30, 2007 from Standard & Poor's, and to secure "Buy" recommendations on its stock from securities analysts.

282. Defendants, however, were concealing a massive secret from shareholders and the investing public, which Morgan Stanley was finally forced to partially disclose on November 7, 2007. Because of the deteriorating subprime markets, and the size of the high-risk proprietary trading positions entered by the Proprietary Trading Group and approved by Cruz and others,

Morgan Stanley had "bet the wrong way" and consequently had amassed a huge undisclosed exposure to subprime assets in a CDS position that could not be unwound. Speculation about potential losses at Morgan due to undisclosed subprime exposure had filtered into the market shortly after Hubler's firing but the nature or scope of these losses were largely unknown because Defendants had intentionally buried or manipulated losses from the CDS positions and related subprime exposures and trading losses in Morgan Stanley's financial reports and earnings releases.

283. On the morning of November 7, 2007, the Wall Street Journal, in an article titled, "Storm May Hit Morgan Stanley After Its Calm --- Write-Downs Projected By Two Analysts," reported that two analysts were projecting write-downs from Morgan Stanley purportedly based on an "educated guess." According to the article:

> Of all the blue-chip Wall Street securities firms, Morgan Stanley seemed one of the least likely to get thumped by the subprime- mortgage crisis. The firm is a bit player in underwriting the securities known as collateralized-debt obligations that have rocked Merrill Lynch, Citigroup and others, ranking a distant No. 10. So why are some on Wall Street starting to sweat about Morgan Stanley's exposure to this business? Two analysts are projecting the firm may take a fourth-quarter write-down of $3 billion to $6 billion. The estimates by analysts David Trone of Fox-Pitt, Kelton and Mike Mayo of Deutsche Bank AG contributed to Morgan Stanley stock's falling $1.08, or 1.94%, yesterday in New York Stock Exchange trading to $54.51 a share. Mr. Trone projected the possible write-downs at $4 billion to $6 billion, Mr. Mayo $3 billion to $4 billion. While the firm may not have underwritten as many CDOs, which are securities backed by pools of assets such as mortgages, Morgan Stanley may have been involved in transactions with other firms that left it with exposure to CDO risks, market participants say. Such proprietary trading with the firm's own money already cost the firm $480 million on money-losing quantitative stock trading in the third quarter, with $390 million in losses occurring on a single day in August, according to regulatory filings. Asked by a CNBC reporter Monday about possible fourth-quarter write-downs, Morgan Stanley Chief Executive John Mack indicated he expected numerous firms would report such hits because market prices have declined. But he wouldn't address specifics about Morgan Stanley.

284. On November 7, 2007, after the close of the U.S. markets, Morgan Stanley shocked investors by announcing that the Company had massive exposures to U.S. subprime positions on its balance sheet that would cause it to suffer billions in losses for the fourth quarter of 2007. Vaguely attributing these losses to "ABS-CDO related positions," Morgan Stanley issued a press release on November 7, 2007, as follows:

> Morgan Stanley (NYSE: MS) today provided additional information about the Firm's U.S. subprime related exposures, which have declined in value as a result of continued market deterioration since August 2007.

At the end of Morgan Stanley's fiscal third quarter on August 31, 2007, the Firm had $12.3 billion in U.S. subprime related balance sheet exposures representing $10.4 billion in net exposures, as indicated in the attached table. Net exposure as of October 31, 2007 is $6.0 billion. Net exposures are defined as potential loss to the firm in a 100 percent loss default scenario, with zero recovery.

Since that time, the fair value of these exposures has declined as a result of the continued deterioration in market data, as reflected by the sharp decline in the ABX Indices, and other market developments, including updates to mortgage remittance data and cumulative loss forecasts. The declines in value are outlined in the attached table as of August 31, 2007 and October 31, 2007.

As a result of these declines in value, Morgan Stanley's revenues for the two months ended October 31, 2007, were reduced by $3.7 billion (representing a decline of approximately $2.5 billion in net income on an after-tax basis). The actual impact on the Firm's fourth quarter financial results, which will include results for the month of November, will depend on future market developments and could differ from the amounts noted.

While these writedowns will negatively impact the fourth quarter results in the Firm's fixed income business, Morgan Stanley expects to deliver solid results in each of its other businesses, including Investment Banking, Equities, Global Wealth Management and Asset Management – subject to market conditions through the end of the year.

Valuation of Subprime Exposures

In determining the fair value of the Firm's ABSCDO-related exposures—which represent the most senior tranches of the capital structure of subprime ABS CDOs—Morgan Stanley took into consideration observable data for relevant benchmark instruments in synthetic subprime markets. Deterioration of value in the benchmark instruments as well as the market developments referred to earlier have led to significant declines in the estimates of fair value. These declines reflect increases in implied cumulative losses across this portfolio. These loss levels are consistent with the cumulative losses implied by ABX Indices in the range between 11-19 percent. At a severity rate of 50 percent, these levels of cumulative loss imply defaults in the range of 40-50 percent of outstanding mortgages for 2005 and 2006 vintages.

In calculating the fair value of the Firm's U.S. subprime mortgage related exposures - including loans, total rate-of-return swaps, ABS bonds (including subprime residuals) and ABS CDS - Morgan Stanley took into consideration observable transactions, the continued deterioration in market conditions, as reflected by the sharp decline in the ABX Indices, and other market developments, including updated cumulative loss data. The fair value of the ABS Bonds declined significantly, which was driven by increases in implied cumulative loss rates applied to subprime residuals at levels consistent with those implied by current market indicators.

It is expected that market conditions will continue to evolve, and that the fair value of these exposures will frequently change and could further deteriorate. Given these anticipated fluctuations, Morgan Stanley does not intend to update this information until it announces its fourth quarter 2007 earnings in December 2007. Investors also should not expect the Company to provide information about the results of future quarters in advance of scheduled quarterly earnings announcement dates.

285. The earnings warning released by the Company on November 7, 2007 was

followed-up by a Form 8-K filing with the SEC the next day on November 8, 2007, with the following explanation:

> On November 7, 2007, Morgan Stanley ("the Company") issued a press release announcing significant declines since August 31, 2007 in the fair value of its U.S. subprime related exposures as a result of the continued deterioration in the market and other market developments. As of August 31, 2007, the Company had $12.3 billion in U.S. subprime related balance sheet exposures representing $10.4 billion in net exposures. Net exposure as of October 31, 2007 was $6.0 billion. Net exposures are defined as potential loss to the Company in a 100 percent loss default scenario, with zero recovery. As a result of the decline in the fair value of these exposures, the Company has determined that the reduction in revenues for the two months ended October 31, 2007 attributable to the decline was $3.7 billion (representing a decline of approximately $2.5 billion in net income on an after-tax basis). The impact on the Company's fourth quarter financial results from changes in the fair value of these exposures will depend on future market developments and could differ materially from the amounts noted. It is expected that market conditions will continue to evolve, and that the fair value of these exposures will frequently change and could further deteriorate.

286. Contemporaneously with the release of its press releases on November 7, 2007, Defendant Kelleher, Morgan Stanley's recently appointed Chief Financial Officer convened analysts on a conference call to attempt to explain how Morgan had suddenly "discovered" these massive U.S. subprime exposures. During the call, Kelleher falsely stated that "as a result of the rigorous processes we have in place, **the [marks] we took back in August appropriately reflected fair value at that time**." (Emphasis added). Kelleher, however, admitted to analysts that Morgan Stanley's subprime exposure could, in no way, be determined from the Company's previous financial disclosures. Asked by one analyst from Merrill Lynch, "Colm, if we had wanted to find these exposures in your second quarter Q and we looked at the VIE asset and maximum exposure to loss data on page 28 and 29 of the Q would have them within the mortgage and asset backed securitization of the structured transactions categories or am I kind of looking in the wrong place?" In response, Kelleher responded, "Well, no, I mean, it's all over the place." Kelleher could not identify anywhere in the previously filed Form 10-Qs in which investors could look to understand these exposures.

287. In response to the initial rumors and then the press release regarding Morgan Stanley's subprime exposures and resulting losses, the Company's stock dropped approximately 8% from a close of $55.59 on November 5, 2007, to a close of $51.19 on November 7, 2007, which

was a 52-week low.

288. On November 8, 2007, Moody's assigned a negative outlook to the senior debt ratings of Morgan Stanley, stating: "The size of the writedown substantially exceeds Moody's prior expectations given Morgan Stanley's limited role in CDO underwriting and conservative risk culture, which should have naturally limited its long exposure. This also raises questions regarding the effectiveness of Morgan Stanley's trading risk management, which has been viewed as an important strength underpinning the Aa3 rating."

289. Moody's further reported on November 8, 2007, that "Morgan Stanley must manage a fine balance between its ability, given its capital and liquidity, to warehouse these positions and the risks that holding this concentrated position would entail. A further write-down that reduces net income by greater than $1 billion would be viewed by Moody's as an indication that risk appetite was higher than anticipated, and would lead to further negative pressure on the rating."

290. On November 9, 2007, the *Financial Times* reported on Morgan Stanley's multi-billion-dollar subprime write-down as follows:

> The [Morgan Stanley] traders had a good idea at the time. Back in December [2006] there were signs that serious problems were developing among U.S subprime mortgage borrowers, but the prices of securities based on such loans were holding up well. So they placed a big bet on a fall in those prices. To do so, they bought insurance against problems with the mortgage-backed securities in the form of credit default swaps. The value of these would rise if the outlook for the securities deteriorated.
>
> To help fund this bet, the [Morgan Stanley] traders also took on billions of dollars of exposure to the "super senior" tranches of collateralized debt obligations. These are instruments composed of mortgage-backed securities divided into slices with varying yields and risks. The top AAA-rated tranches were seen as being very safe, because any likely losses on the underlying securities would be absorbed by investors in the lower tranches. Nevertheless, the senior trances offered a good yield which helped offset the cost of the bet.
>
> The value of mortgage-backed securities fell so far it ate into the cushion under the super senior tranches and the started to fall. At one point in the summer, the impact on the CDO tranches started to outweigh the rise on the CDS positions. "It went from a structurally short position to a structurally long position," said Colm Kelleher, Morgan Stanley's chief financial officer.

291. The ABX index was falling precipitously as early as July 2007, which plainly demonstrates that Kelleher's claim set forth above in ¶ 286 that Morgan Stanley's ABS positions

were marked-to-market in August 2007 was materially false and misleading. The partial disclosures made by the Company on November 7 and 8, 2007, continued to mask the massive subprime exposure that the Company's Proprietary Trading desk had created for Morgan Stanley.

292. During the conference call on November 7, 2007, for the first time, Kelleher disclosed that illiquidity in the market was limiting Defendants' ability to get out of positions in the subprime class. He attributed the decline in the valuation of the subprime-related assets to a "sharp" decline in the ABX indices, but he knowingly and recklessly continued to conceal the fact that this same ABX index had declined in Third Quarter 2007 and that Defendants had deliberately failed to value the CDS position at fair value at the end of Third Quarter. To the contrary, Defendant Kelleher falsely stated that the "marks we took back in August appropriately reflected fair value at that time."

293. On November 13, 2007, Defendants Cruz and Kelleher participated in a presentation at the Merrill Lynch Banking and Financial Services Investor Conference. Defendant Kelleher fielded questions from investors regarding Morgan's recently-disclosed multi-billion-dollar losses, and in emphasizing the need for full disclosure to reduce any uncertainty arising from fair value accounting, he stated as follows:

> Level 3 assets have always been there, it's just that we recapitalized them according to fair value. What you have to do is look at what makes up those balances and then focus. I think what we did last week with the disclosure we made was to give you a lot of insight into what made up some of those balances in the derivatives part of our disclosure at the end of 3Q. I think that's the only way you address this issue.
>
> ***
>
> I have consistently said the fact that we reduced our position proves to the robustness of the risk management model because we addressed that issue rather than rolling the dice that some people do....On the second trade, we actually had a risk management model that told us what was happening because I think, as I explained last week, the nature of the trade itself was changing because basically our [ ] money positions were rapidly becoming into the money, and our risk management systems were alerting us to the fact what we thought was a structural short trade evolved into a flat trade, evolved into us being wrong, coinciding with a market where there was no liquidity to get out. I think there were a few things we've learned from that trade in terms of looking back on it. And obviously, we will address those issues accordingly in our risk management model and within the firm itself....I don't think that our risk management models upfront would have pointed out what was happening on these trades. These were incredibly stressed markets...

294. Kelleher's comments deliberately gave the false impression that Morgan's losses from the trade were fully disclosed and in the past. He also materially misrepresented the nature and timing of information from stress tests (ordered by Cruz) that were known to Defendants regarding the Company's high-risk bet on subprime and the fact that Defendants knew or recklessly disregarded that the Proprietary Trading Group had "bet the wrong way" on a $13.2 billion subprime CDS position. Kelleher also falsely stated that Defendants had not rolled the dice, when, according to several news reports, Defendants had opportunities to cut their positions, but they did not do so because they did not like price quotes that were being given by counterparties to unwind the CDS position. In fact, according to an article by John Macaskill in *IFR*, Risk Officers to the Fore, dated April 12, 2008, Defendants passed on opportunities to unwind the position during the Class Period that would have limited Morgan's losses to $1 billion. Kelleher also failed to acknowledge that Cruz was worried as early as May of 2007, while Daula claims he sounded alarms regarding debilitated systems and models by no later than August 2007.

295. Defendants' statements in the November 7, 2007, press release and conference call were materially false and misleading when made and omitted to disclose material facts necessary to make the statements made not misleading because they failed to disclose the following materially adverse facts that Defendants knew and deliberately and recklessly disregarded:

(a) Defendants were aware that liquidity in the CDO market had tightened and that risks of catastrophic material losses arising from the Proprietary Trading Group's CDS position had increased and further material losses likely would materialize in Fourth Quarter 2007;

(b) Defendants had failed to implement adequate internal controls and risk management for its proprietary trading, and Morgan Stanley's risk measurement systems had not performed well;

(c) Defendants failed to disclose adequately the Company's subprime exposure from unrecognized losses in Third Quarter 2007 and that additional mark-to-market losses were needed to catch up for losses unrecorded in the previous 11 months of fiscal 2007;

(d) Defendants failed to disclose that the Company was positioned to record billions of dollars in more losses from a single trading strategy that could and ultimately did wipe out a material percentage of the Company's annual income and trigger ratings agency downgrades; and

(e) Morgan Stanley's CDS positions were not recorded at fair value, and Defendants had ignored observable inputs from Level 2 and used subjective

> unobservable inputs from Level 3 to manipulate the Company's reported financial results and overstate income.

296. The true impact of Morgan Stanley's undisclosed high-risk trading in subprime-related securities was not revealed until December 19, 2007, when the Company released its earnings for the fourth quarter and fiscal year ended November 30, 2007. In the earnings release, Morgan Stanley finally disclosed that its total write-down of U.S. subprime, and other mortgage related exposures, for the fourth quarter was approximately $9.4 billion, of which $7.8 billion was attributed to the Proprietary Trading Desk's "bet the wrong way" on the subprime CDS positions. The earnings release disclosed, in pertinent part, the following:

> The additional $5.7 billion writedown of U.S. subprime, and other mortgage related exposures in November, and the $3.7 billion writedown as of October 31 (as announced on November 7), result in a total fourth quarter writedown of approximately $9.4 billion. In total, these writedowns reduced full year earnings per diluted share from continuing operations and the return on average common equity from continuing operations by approximately $5.80 and 19 percentage points, respectively.
>
> The loss from continuing operations for the fourth quarter was $3,588 million, or $3.61 per diluted share, compared with income from continuing operations of $1,982 million, or $1.87 per diluted share, in the fourth quarter of 2006. Net revenues were negative $450 million, compared with $7,849 million in last year's fourth quarter. Non-interest expenses of $5.4 billion increased 3 percent from last year. Net income for the year was $3,209 million, or $2.98 per diluted share, compared with $7,472 million, or $7.07 per diluted share, a year ago. The return on average common equity for the year was 8.9 percent compared with 23.5 percent a year ago. For the quarter, the net loss was $3,588 million, or $3.61 per diluted share, compared with net income of $2,206 million, or $2.08 per diluted share, in the fourth quarter of 2006.
>
> * * *
>
> **Actions to Address Disruption in Mortgage Securities Market and Build on Momentum Across Business**
>
> Morgan Stanley has taken a number of actions to address the disruption in the mortgage securities market and continue building on the momentum across most of its businesses, including:
>
> · Putting in place new senior leaders, including appointing Walid Chammah and James Gorman as Co-Presidents, naming Michael Petrick as Global Head of Sales and Trading and making a series of other management changes throughout the Institutional Securities business;
>
> · Further enhancing the Firm's risk management function by strengthening staffing and having it report directly to Chief Financial Officer, Colm

> Kelleher, and creating a new, additional risk monitoring function within the trading business, which will report to Mr. Petrick; and
>
> · Consolidating all of the Firm's proprietary trading activities under common leadership, reporting to Mr. Petrick.
>
> **Fourth Quarter Writedowns Reflects Continued Deterioration in the Mortgage Markets**
>
> During the fourth quarter, the Firm recognized a total of $9.4 billion in mortgage related writedowns as a result of the continued deterioration and lack of liquidity in the market for subprime and other mortgage related securities since August 2007. Of this total, $7.8 billion represents writedowns of the Firm's U.S. subprime trading positions (including the $3.7 billion writedown of subprime assets announced on November 7, based on valuations as of October 31). As indicated at the time of that announcement, year-end valuations depended on subsequent market conditions. Our valuation of this position as of November 30 takes into consideration a variety of inputs including observable trades, the continued deterioration in market conditions, the decline in the ABX Indices, other market developments, including mortgage remittances and updated cumulative loss data. The Firm's remaining direct net U.S. subprime exposure is $1.8 billion at November 30, down from $10.4 billion at August 31. The value of these positions remains subject to mark-to-market volatility.

297. According to the fiscal year-end earnings release, Morgan Stanley's Institutional Securities business segment reported pre-tax income of $817 million for the full fiscal 2007 year, which was an 89% decrease from 2006. The Company also reported that "Net revenues decreased 24 percent to $16.1 billion as record results in equity sales and trading, advisory and underwriting were more than offset by lower results in fixed income sales and trading," and that "Fixed income sales and trading revenues were $0.7 billion, down 93 percent from 2006 reflecting significant losses in credit products resulting from the mortgage related writedowns." For Fourth Quarter 2007, the Company reported a pre-tax loss of ($6.5 billion) for the Institutional Securities business segment, which decreased from $2.2 billion of pre-tax income in the fourth quarter of 2006, and loss of $3.4 billion in net revenues, compared with net revenues of $5.5 billion in fourth quarter 2006.

298. To offset the bleak financial report, Morgan Stanley highlighted an immediate $5 billion capital infusion and boldly announced that an approximate $5 billion investment from China Investment Corporation was going to "bolster" the Company's "strong" capital position.

299. Defendant Mack stated on the earnings conference call held on December 19, 2007,

that "[t]he results we announced today are embarrassing for me, for our firm, this loss was the result of an error in judgment that occurred on one desk, in our Fixed Income area, and also a failure to manage that risk appropriately. Make no mistake, we've held people accountable. We're moving aggressively to make the necessary changes."

300. Defendant Kelleher also participated in the earnings conference call on December 19, 2007. Kelleher responded to questions from analysts regarding the Company's Level 3 assets and liabilities, although he avoided describing what the biggest "component" was of Level 3. Kelleher explained only that "obviously there was on very big mark that ran through Level 3, which we've just announced."

301. On the earnings conference call, William Tanona of Goldman Sachs, asked the question that everyone was thinking: "Just if we could ask you a question on the risk again. I know everybody has been dancing around it, but I guess my question would be more, help us understand how this could happen that you could take this large of a loss[?] I mean, I would imagine that you guys have position limits and risk limits as such. It just behooves me to think that you guys could have one desk that could lose $8 billion."

302. In response to this question, John Mack answered:

> Bill, look, lets be clear. One, this trade was recognized and entered into our account. Two, it was entered [sic] our risk management system. It's very simple. It's very painful, so I'm not being glib. When these guys stressed loss the scenario from putting on this risk position they did not vision in their stress losses that we could have this degree of default, right? It is fair to say that our risk management division did not stress those losses as well. It's as simple as that. Think [sic] was a big fat tail risk that caught us hard, right? That's what happened. Now, with hindsight, can you catch these things? We are not unique in being along [sic] these positions, right? What is unique is that this was a trade that was put on as a proprietary trade and we have learned very expensive, and by the way, Bill, a humbling lesson, okay?"

303. As is now known, Defendant Mack's testy response to the inquiry from the analyst from Goldman Sachs was a complete fabrication. In fact, throughout the Class Period, Defendants had knowingly and recklessly misrepresented to investors and shareholders the true nature of Morgan Stanley's risks and internal controls and protocols. Defendants deliberately and recklessly failed to disclose the Company's massive subprime exposure; failed to monitor and control risks from Mack's directives to increase proprietary trading risks; and failed to disclose resulting losses

from the Proprietary Trading Group's high-risk subprime trades until Defendants could no longer conceal the truth in December 2007.

304. On December 19, 2007, Morgan Stanley's stock price increased to close at $50.58, from the prior day's close of $48.07, as Defendants were able to soften the blow of the additional material losses with news of China's $5 billion lifeline of capital.

Post-Class Period Disclosures

305. On December 21, 2007, *FinancialTimes*.com reported as follows:

> Morgan Stanley is one of several leading Wall Street banks that are overhauling their risk management after announcing billions of dollars of losses on subprime-related investments.
>
> UBS (NYSE:UBS) , Citigroup (NYSE:C) and Merrill Lynch have all lost their chief executives and a number of other senior executives following the writedowns.
>
> John Mack, who has kept his job as Morgan Stanley's chief executive, last month ousted Zoe Cruz, co-president, who ran the group's securities businesses. The latest review could influence Mr. Mack's ability to weather the storm.
>
> Mr Daula, who was appointed to his role in 2005, briefed Ms Cruz weekly on the bank's risk position, according to people familiar with the matter, although one said Mr Daula never took his concerns directly to Mr Mack.
>
> The decision on Mr Daula's future will shed light on whether the blame for the losses is seen to lie with the people responsible for monitoring risk or with more senior executives.
>
> By all accounts, Mr Daula had an impressive knowledge of the activities of traders in the so-called structured product group, particularly those who placed the trades that went so badly wrong.
>
> By August, Mr Daula was very vocal in saying that there were no proper pricing models for such trades, that positions were not being properly measured, and that the history traders used in their models was not a reliable guide, these people say.
>
> But by the time senior executives at Morgan Stanley say they realised how dangerous these positions were, it was impossible to cut them.

306. On January 29, 2008, Morgan Stanley filed its Annual Report on Form 10-K for fiscal 2007 with the SEC. The Form 10-K provided additional disclosures regarding the classification of the Company's subprime-related assets, as follows:

> The Company's primary exposure to ABS CDOs is to synthetic CDOs that hold or are referenced to collateral with ratings of BBB+, BBB or BBB-

> ("mezzanine CDOs"). The majority of the Company's writedowns in the fourth quarter related to super senior credit default swaps referencing such mezzanine CDOs that were entered into primarily by the Company's proprietary trading group. Under these credit default swap arrangements, the Company can be required to make payments in the event that securities in the referenced portfolios default or experience other credit events such as rating agency downgrades. (The characterization of these credit default swaps as "super senior" derives from their seniority in the capital structure of the synthetic CDO.) The Company also has exposure to ABS CDOs via other types of credit default swaps, direct investments in CDO securities, and retained interests in CDOs that the Company has underwritten. In determining the fair value of the Company's ABS CDO-related instruments the Company took into consideration prices observed from the execution of a limited number of transactions and data for relevant benchmark instruments in synthetic subprime markets. Despite the fact that actual defaults on swap obligations have not yet been realized, the fair value of such positions has experienced significant declines, as a result of a deterioration of value in the benchmark instruments as well as market developments.

307. The next day, on January 29, 2008, Morgan disclosed that it was responding to government subpoenas concerning "the origination, purchase, securitization and servicing of subprime and non-subprime residential mortgages and related issues."

X. MORGAN STANLEY'S ACCOUNTING VIOLATED GAAP AND SEC DISCLOSURE REQUIREMENTS

A. Morgan Stanley's Financial Statements Failed to Comply with GAAP

308. Generally Accepted Accounting Principles, *i.e.*, GAAP, are those principles recognized by the accounting profession and the SEC as the conventions, rules, and procedures necessary to define accepted accounting and reporting practices at a particular time. GAAP is promulgated in part by the American Institute of Certified Public Accountants ("AICPA") and consists of a hierarchy of authoritative literature established by the AICPA. The highest level in the hierarchy includes Financial Accounting Standards Board Statements of Financial Accounting Standards (SFAS), Financial Accounting Standards Board Interpretations (FIN), Accounting Principles Board Opinions (APB) and AICPA Accounting Research Bulletins (ARB).

309. The SEC requires that public companies prepare their financial statements in accordance with GAAP. As set forth in Rule 4-01(a) of SEC Regulation S-X, "[f]inancial statements filed with the [SEC] which are not prepared in accordance with [GAAP] will be presumed to be misleading or inaccurate, despite footnote or other disclosures." Regulation S-X requires that interim financial statements, such as these filed in Morgan Stanley's Form 10-Qs, must

also comply with GAAP, with the exception that interim financial statements need not include disclosure which would be duplicative of disclosures accompanying annual financial statements.

310. Management is responsible for preparing financial statements that conform to GAAP. As noted by AICPA auditing standards ("AU"), § 110.02:

> Financial statements are management's responsibility... [M]anagement is responsible for adopting sound accounting policies and for establishing and maintaining internal controls that will, among other things, record, process, summarize, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities and equity are within the direct knowledge and control of management... Thus, the fair presentation of financial statements in conformity with Generally Accepted Accounting Principles is an implicit and integral part of management's responsibility.

311. As alleged elsewhere herein, prior to and throughout the Class Period Defendants deliberately caused the Company increase its level of risk for proprietary trading, including trading subprime mortgage-related securities and derivatives.

312. Exercising the "trader's option" as encouraged by Defendant Mack, Morgan's Proprietary Trading Group employed subprime-related speculative trading strategies on CDS positions that exposed Morgan Stanley to an undisclosed excessive amount of risk. The positions proved profitable during the first half of 2007, although not quantifiable from Morgan Stanley's financial statements. During the second-half of 2007, things began to sour, as conditions in the tumbling credit market, such as lack of liquidity, declining home values and increasing credit delinquencies and defaults, caused the value of these speculative positions to drop significantly.

313. Defendants failed to account properly for the mounting losses in the CDS positions throughout the first nine months of the fiscal year ending August 31, 2007. The Company's quarterly SEC filings and interim financial statements in Third 2007 not only failed to recognize known losses related to the significant declines in the value of its subprime-related securities, but the Company's Second and Third Quarter Form 10-Qs also failed to disclose Morgan Stanley's exposure to these dangerously risky securities and potentially-massive related losses. In fact, the Company's Third Quarter 2007 Form 10-Q filed on October 10, 2007 barely included the word "subprime"; however, less than one month later, on November 7, 2007, the losses were so enormous

that Defendants were forced to file a Form 8-K announcing a $3.7 billion write-down related to the Company's subprime exposures as of October 31, 2007.

314. The Company's income and net earnings were materially overstated and liabilities were materially understated as reported in the Company's Third Quarter 2007 earning release and Form 10-Q financial statements. Additionally, the Company's financial statements for the Second and Third Quarters of 2007 lacked required disclosures and omitted material facts regarding the Company's actual losses from, and future exposure to, subprime-related securities. By the end of November 30, 2007 fiscal year, Morgan recognized total net write-downs from this speculative and undisclosed foray into the subprime market of approximately $7.8 billion. Throughout the Class Period, the Company had issued risk disclosures and ineffective internal control and procedures over financial reporting, despite contrary certifications signed by Defendants Mack and Sidwell. As a publicly-traded company, Morgan Stanley was required to maintain books and records in sufficient detail to reflect the transactions of the Company and therefore prepare financial statements in accordance with GAAP. Specifically, under the Exchange Act public companies must:

> (a) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
>
> (b) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that i. transactions are executed in accordance with management's general or specific authorization; ii. transactions are recorded as necessary (i) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (ii) to maintain accountability for assets....

315. During the Class Period, Morgan's publicly-filed financial statements violated numerous provisions of GAAP, including the following:

a. The principle that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions, (FASB Statement of Financial Accounting Concepts – "SFAC" No. 1);

b. The principle that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events, and circumstances that change resources and claims to those resources, (SFAC No. 1);

c. The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it. To the extent that management offers securities of the enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective investors and to the public in general, (SFAC No. 1);

d. The principle that financial reporting should provide information about an enterprise's financial performance during a certain time period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance, (SFAC No. 1);

e. The principle that the quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form. (SFAC No. 2);

f. The principle that financial reporting should be reliable in that it represents what it purports to represent. That information should be reliable as well as relevant is a notion that is central to accounting, (SFAC No. 2);

g. The principle of completeness, which means that nothing is left out of the information that may be necessary to insure that it validly represents underlying events and conditions, (SFAC No. 2);

h. The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered, (SFAC No. 2);

i. The principle that losses be accrued for when a loss contingency exists, (Statement of Financial Accounting Standards –"SFAS" No. 5);

j. The principle that if no accrual is made for a loss contingency, then disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred, (SFAS No. 5);

k. The principle that contingencies and other uncertainties that affect the fairness of presentation of financial data at an interim date shall be disclosed in interim reports in the same manner required for annual reports, (Accounting Principles Board – "APB" Opinion No. 28);

l. The principle that disclosures of contingencies shall be repeated in interim and annual reports until the contingencies have been removed, resolved, or have become immaterial, (APB Opinion No. 28);

m. The principle that management should provide commentary relating to the effects of significant events upon the interim financial results. (APB Opinion No. 28); and

o. The principle that disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the

> methods of applying those principles that materially affect the financial statements, (APB Opinion No. 22).

316. Defendants caused Morgan to violate the foregoing provisions of GAAP: (1) by failing to disclose the existence and risk exposure of its proprietary subprime positions in each of its interim financial statements during fiscal 2007; (2) by failing to maintain a proper risk management program that would have alerted management of its precarious exposure and inevitable losses relating to its proprietary subprime positions during 2007; and (3) by failing to maintain proper internal accounting controls, which resulted in the material misstatements to the Company's financial statements during fiscal 2007.

317. Defendants similarly caused Morgan to violate SEC disclosure requirements. Under SEC regulations, management of a public company has a duty "to make full and prompt announcements of material facts regarding the company's financial condition." The SEC has emphasized that "[i]nvestors have legitimate expectations that public companies are making, and will continue to make, prompt disclosure of significant corporate developments."

318. In Accounting Series Release 173, the SEC reiterated the duty of management to present a true representation of a company's operations:

> [I]t is important that the overall impression created by the financial statements be consistent with the business realities of the company's financial position and operations.

319. The SEC also requires in every Form 10-Q filing in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), that the issuer furnish information required by Item 303 of Regulation S-K. The MD&A requirements are intended to provide, in one section of a filing, material historical and prospective textual disclosures enabling investors and other users to assess the financial condition and results of operations of the company, with particular emphasis on the company's prospects for the future. To further explain what must be included by Item 303 in MD&A, the SEC issued an interpretive release as follows:

> The Commission has long recognized the need for a narrative explanation of the financial statements, because a numerical presentation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance. MD&A is intended to give the investor an opportunity to look at the

> company through the eyes of management by providing both a short and long term analysis of the business of the company. The Item asks management to discuss the dynamics of the business and to analyze the financials.

320. The SEC also has stated, "[i]t is the responsibility of management to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company."

321. SEC Staff Accounting Bulletin No. 101 ("SAB 101"), *Revenue Recognition in Financial Statements*, also reiterates the importance of MD&A in financial statements:

> Management's Discussion & Analysis (MD&A) requires a discussion of liquidity, capital resources, results of operations and other information necessary of a registrant's financial condition, changes in financial condition and results of operations. This includes unusual or infrequent transactions, known trends, or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue, operating income or net income and the relationship between revenue and the costs of the revenue. Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease. The Commission stated in Financial Reporting Release (FRR) 36 that **MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future."** (Emphasis added; footnotes omitted).

322. In discussing results of operations, Item 303 of Regulation S-K requires the company to "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." The Instructions to Paragraph 303(a) further state, "[t]he discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results."

323. With respect to results of operations, the SEC guides management to:

- Describe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected. In addition, describe any other significant components of revenues or expenses that, in management's judgment, should be described in order to understand the results of operations; and

- Describe any known trends or uncertainties that have had or that management reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

324. Despite the SEC mandate that the MD&A discuss "unusual" transactions "that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue," Defendants failed to disclose the true nature of Morgan's subprime trading strategies and the resulting net exposure in its Class Period public filings.

325. Defendants' concealment of the magnitude of Morgan's subprime trading losses and net exposure on the Company's CDS positions was particularly significant for the investing public because it deprived them of the knowledge that the Company had suffered significant losses due to speculative subprime trading strategies and that the apparent illiquidity in the credit markets was preventing Morgan from mitigating future losses. It is for precisely this reason that the SEC in SAB 101, citing Financial Reporting Release No. 36 (promulgated by the SEC), explained that the MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future."

326. Rather than complying with the spirit and intent of disclosure requirements set forth in the above regulations, Morgan's SEC filings reveal a deliberate manipulation of its disclosures relating its subprime trading strategies and exposures, failing to disclose (i) the level of losses incurred on a timely basis, and (ii) that the apparent illiquidity in the credit markets was preventing Morgan from mitigating significant future losses.

327. In addition, the SEC has indicated that companies should employ the following two-step analysis in determining when a known trend or uncertainty is required to be included in the MD&A disclosure pursuant to Item 303 of Regulation S-K: (a) a disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management; and (b) is reasonably likely to have a material effect on the registrant's financial condition or results of

operations.

328. The MD&A section of Morgan's SEC filings during the Class Period failed to comply with these SEC regulations because: (1) Defendants failed to disclose the proprietary trading strategy that caused the Company to enter into large speculative subprime positions; (2) Defendants did not disclose the fact that the Company had suffered significant losses due to these speculative subprime trading positions; (3) the illiquidity in the credit markets was preventing MS from effectively mitigating future losses on these speculative positions; and (4) Defendants Mack and Sidwell certified to shareholders and investors that Morgan Stanley's internal financial reporting and disclosure controls were adequate, when they were not.

329. Each of Defendants' improper accounting practices, misrepresentations and omissions standing alone, was a material breach of GAAP and/or SEC regulations.

B. Morgan Stanley Violated GAAP in Valuing Certain Subprime Positions

330. Defendants significantly overstated the value of assets with exposure to subprime-related securities and similarly understated the value of its related liabilities in Morgan's public filings during fiscal 2007. These misstatements resulted in corresponding overstatements of trading revenue, net revenue, income from continuing operations and net income in Morgan's Income Statements during the Class Period. In addition, the misstatements resulted in overstatements in financial instruments owned, total assets, retained earnings, and total shareholders equity and understatements in financial instruments sold, not yet purchased and total liabilities within Morgan's consolidated financial statements.

331. Defendants orchestrated this fraud to avoid valuing the CDS positions in accordance with the relevant benchmark ABX Index, which was a significant Level 2 input that Defendants typically used to value billions of dollars worth of subprime-related assets and liabilities, including the $13.2 billion long CDS position. To avoid recording losses in accordance with the ABX for the third quarter of 2007, Defendants utilized self-serving subjective Level 3 valuation criteria to apply artificially-high values to these assets and artificially-low values to these liabilities in order to minimize material loss recognition.

332. Other than certain subprime positions owned by the Company's subsidiary banks,

the majority of Morgan Stanley's subprime positions were identified in SEC filings as "trading positions."

333. Pursuant to SFAS No. 115, *Accounting for Investments in Certain Debt and Equity Securities*, securities that are bought and held principally for the purpose of being sold in the near term are to be classified as "trading securities." GAAP requires such trading securities to be carried at fair value in the statement of financial condition and all mark-to-market (unrealized) gains and losses on trading securities are recognized in the current period's income statement. Consequently, Morgan Stanley was required to carry its CDS positions at "fair value" on its Statement of Financial Position.

334. Under SFAS No. 157, fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants." As set forth above in Section VI.E.3, this statement establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Level 3 is the lowest level, is the least desirable and least reliable as its uses assumptions developed by the reporting company to determine fair value. SFAS 157 also expands the disclosure requirements about fair value measurements of Level 3 assets.

C. Defendants Failed to Recognize Observable Inputs for Valuation of the CDS Positions

335. By changing the valuation inputs for the CDS positions from observable Level 2 inputs to subjective Level 3 inputs, Defendants improperly valued Morgan's CDS positions and attempted to justify minimizing the losses related to the significant decline in value in them as of August 31, 2007. In so doing, Morgan violated SFAS No. 115 and SFAS No. 157.

336. Reporting the move of assets and liabilities from Level 2 to Level 3 was a mechanism Defendants employed to establish a rationale to avoid the recognition of losses tied to the collapsing subprime markets after Morgan's Proprietary Trading Group "bet the wrong way" on

massive subprime positions. As discussed below, significant observable inputs did exist for assets and liabilities that were reclassified to Level 3. Defendants improperly ignored the ABX Index in order to avoid the full recognition of the collapsing value of its CDS positions that was being reflected by the Index's decline.

337. According to the Form 10-K for fiscal year ending 2007, the largest write-downs and exposure to the Company were CDSs referencing synthetic mezzanine CDOs. Under these credit default swaps, the Company sold credit protection on a notional amount of $13.2 billion of synthetic CDOs. The ABX Index was the most relevant observable input available to value these CDSs. During the quarter ended August 31, 2007, Defendants ignored observable data available from the ABX Index for valuation purposes in violation of GAAP. Specifically, Defendants ignored the ABX Index because it was signaling plummeting values of subprime securities and Defendants used unreasonable subjective valuation methodologies to avoid taking a loss on the long CDS position.

338. Defendants' unjustified manipulation of valuation for Morgan's CDS positions, regardless of whether the assets and liabilities were classified at Level 2 or Level 3, was a violation of SFAS No. 157. The AICPA Center for Audit Quality (CAQ) Alert # 2007-51 dated October 3, 2007, and the white paper analysis that supplemented it, "Measurements of Fair Value in Illiquid (or Less Liquid) Markets," each discuss the existing guidance on measurement of fair value as contemplated by SFAS No.157. This Alert and white paper reinforce the inappropriateness of the changes in subprime valuation inputs selectively done by Morgan Stanley during the Third Quarter of 2007. The following excerpts from the white paper confirm that Defendants' improper use of valuation inputs and the rejection of significant observable data from the ABX Index, even where there is increasing illiquidity, was inappropriate, and in violation of SFAS No. 157:

a. It is important to distinguish between an imbalance between supply and demand (e.g., fewer buyers than sellers thereby forcing prices down) and a "forced" or "distressed" transaction.

b. The fact that transaction volume in a market is significantly lower than in previous periods does not necessarily mean that these are forced or distressed sales.

c. Persuasive evidence is required to establish that an observable transaction is a forced or distressed transaction. It is not appropriate to assume that all transactions in a relatively illiquid market are forced or distressed transactions.

d. It would not be appropriate to disregard observable prices, even if that market is relatively thinner as compared to previous market volume. Even if the volume of observable transactions is not sufficient to conclude that the market is "active," such observable transactions would still constitute Level 2 inputs that must be considered in the measurement of fair value.

339. The Form 8-K filed by Morgan on November 7, 2007, included the first description ever of the Company's subprime positions and included a reference to the valuation inputs used by Defendants in determining the fair value of its hemorrhaging subprime CDS position.

> In determining the fair value of the Firm's ABS CDO-related exposures – which represent the most senior tranches of the capital structure of subprime ABS CDOs – Morgan Stanley took into consideration observable data for relevant benchmark instruments in synthetic subprime markets. Deterioration of value in the benchmark instruments as well as the market developments referred to earlier have led to significant declines in the estimates of fair value. These declines reflect increases in implied cumulative losses across this portfolio. These loss levels are consistent with the cumulative losses implied by ABX Indices in the range between 11-19 percent. At a severity rate of 50 percent, these levels of cumulative loss imply defaults in the range of 40-50 percent of outstanding mortgages for 2005 and 2006 vintages.

340. The Company's disclosures expressly state that the subprime market is highly correlated to the ABX Index. The ABX Index reflects the willingness of investors to buy and sell credit protection in the form of credit defaults swaps on the basis of their view about the risk of the underlying subprime loans. The ABX has five separate indices based on the rating of the underlying subprime securities, ranging from AAA to BBB-. The index does not reflect the absolute fair value of the underlying bonds, but rather it offers a gauge of the demand for them. A decline in the ABX suggests that CDS protection costs have increased because the underlying bonds have become more risky and investors have less confidence in them.

341. According to SFAS No. 157, "This statement emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability."

342. The industry standard in tracking and valuing CDS transactions and values is the independent ABX indices. According to Citigroup CFO, Gary Crittendon, in an interview regarding the extent of subprime troubles, "the best way to kind of get an outside perspective on this is to look at the ABX Indices." Nevertheless, in order to avoid recognizing the full extent of impairment that was apparent from utilizing this observable data (Level 2 inputs) and valuing the CDS positions accordingly, Defendants instead used internally developed pricing models (Level 3 inputs) that gave the impression of higher asset and lower liability values, and therefore lower loss recognition as of August 31, 2007.

343. SFAS No. 157, ¶ 21, states that "Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs." Defendants did exactly the opposite. Defendants deliberately and recklessly failed to maximize the use of the ABX indices, which would have resulted in a direct correlation between the significant drop in the indices and the Company's valuing of its CDS positions. In so doing, Morgan failed to reflect properly CDS positions at fair value and as a result violated both SFAS No. 115 and SFAS No. 157. Defendants disclosed the ABX Indices as one component of its pricing of its CDS positions, but they did not use it as the direct observable input for pricing these positions, because this would have forced the Company to take significantly higher write-downs as of August 31, 2007.

344. The ABX Index reflects trading values for CDSs. Consequently, there is a direct correlation between these index values and the values of Morgan Stanley's CDS positions. Clearly, this index is a Level 2 observable input, and should have been used by MS in its valuation of its CDS, regardless of whether the CDSs were classified at Level 2 or Level 3.

345. This index is so indicative of subprime securities values such as CDS, that the AICPA in a release dated October 3, 2007, stated that these indices are even suitable as a Level 2 input to value securities backed by subprime mortgage loans. Furthermore, a commercial banking standards setting agency, the Bank for International Settlements, the entity that controls the CDS market, as well holds that the ABX index values are so controlling, that "to obtain estimates of mark to market losses for subprime MBS, ABX prices, by rating and vintage, can simply be applied to

outstanding volumes of these securities."

346. Nevertheless, despite the direct correlation to CDS values and the readily available ABX indices, Defendants deliberately and secretly ignored this data source. In the Form 10-K for fiscal 2007, the Company's description of its positions included:

> The Company's primary exposure to ABS CDOs is to synthetic CDOs that hold or are referenced to collateral with ratings of BBB+, BBB or BBB- ("mezzanine CDOs"). The majority of the Company's write-downs in the fourth quarter related to super senior credit default swaps [CDS] referencing such mezzanine CDOs that were entered into primarily by the Company's proprietary trading group. Under these credit default swap [CDS] arrangements, the Company can be required to make payments in the event that securities in the referenced portfolios default or experience other credit events such as rating agency downgrades.

D. Defendants Failed to Value Assets and Liabilities Based on Current Market Conditions

347. The ABX Index for BBB.06-1 vintage, acknowledged by Kelleher as the vintage where Morgan Stanley's most significant exposure rests, showed a 32.8% decrease between the end of Second and Third Quarter 2007. During the same period, based on the limited information specific to its subprime positions disclosed by Morgan, the Company recognized only a 14.4% write-down on its Mezzanine CDS positions. For a $13.2 billion CDS long position, as disclosed by the Company, a 32.8% decrease in value would equate to a loss of $4.4 billion. This compares to a recognized loss of only $1.9 billion taken by Morgan Stanley on these positions. Had Defendants appropriately valued Morgan's CDS position in conformity with the Level 2 values reflected by the ABX index, then the write-downs in the Third Quarter 2007 would have been $2.5 billion higher.

348. Morgan (while Mack was President and Chief Operating Office during his early days with the Company) has demonstrated the propensity to fraudulently value assets and overstate its earnings and financial condition in the past. In November 2004, the Company agreed to a cease and desist order in which the SEC found that the Morgan had overvalued certain high-yield bonds by failing to properly value the bonds as of the current measurement date. Instead, Morgan took a "longer view" as to their value, by discounting, or ignoring current market conditions, much as Defendants did in the Second and Third quarters of 2007 with respect to the ABX Index values. The SEC order stated that "Morgan Stanley believed that market conditions rendered third-party

price quotations unreliable." In such market conditions, GAAP required Morgan Stanley to use its best efforts to determine the fair value of the bonds, which is the price at which a willing buyer and a willing seller would enter into a current exchange. Instead of following GAAP to determine the fair value for those bonds, Morgan Stanley valued those bonds by "taking a longer view of the market" and essentially put its subjective opinion about the value of the bonds ahead of prices quoted by external pricing sources." By overvaluing those bonds, the SEC concluded that "Morgan Stanley's financial results for the fourth quarter of fiscal year 2000, as reported on filings made with the Commission, were misstated and not in conformity with GAAP."

349. In this same order, the SEC also found that the Company similarly overvalued certain aircraft leasing assets during the slump period in that industry brought about by the September 11, 2001 terrorist attacks. MS used a contrived valuation method not in compliance with GAAP to determine the value of certain impaired aircraft in its portfolio. The Company used a "base value" method that estimated the value of aircraft "presuming a transaction between an equally willing and informed buyer and seller, neither under compulsion to buy or sell, and with supply and demand for the aircraft in reasonable balance." As with the high-yield bonds, Morgan failed to consider the current market conditions to calculate fair value. As a result of overvaluing the aircraft assets, the SEC concluded that "Morgan Stanley's financial results for the fourth quarter of fiscal year 2001, third quarter of fiscal 2002 and the first quarter of fiscal 2003, as reported on filings made with the Commission, were misstated and not in conformity with GAAP."

350. Defendants ignored the current market conditions, changed valuation inputs from observable Level 2 inputs to unobservable Level 3 inputs to try to justify their failure to use the ABX Index, and employed an old manipulative strategy to take a "longer view" of the market. This was done in order to "manage earnings." According to *Businessweek.com*, 15 analysts had established earnings estimates for MS for the Third Quarter 2007. The Consensus earnings estimate was $1.54 per share. However, the high end of the range was $1.86 and the low end was $1.38. MS reported earnings of $1.38. It is apparent that MS contrived its valuation of its CDS positions in order to recognize only enough impairment to still meet the low end of earnings expectations.

351. While the Third Quarter valuation is not consistent with the ABX, MS admitted that

the Fourth Quarter valuation was based on the ABX, despite worsening liquidity issues in the market relative to the Third Quarter. The high correlation between the ABX index for the BBB.06-1 and the Company's Mezzanine CDS positions was evidenced in the Company's results recorded for the six months ended November 30, 2007. The six-month write-downs taken by the Company on these positions reflected losses of 68.2%. This amount is actually in excess of the 65.1% decrease in the index during the same period.

352. After failing to recognize sufficient write-downs in the quarter ended August 31, 2007, the Company recorded write-downs in the fourth quarter ended November 30, 2007 that exceeded the actual decrease in the respective ABX index during that quarterly period. It is apparent that Morgan Stanley needed to get the recorded fair values in sync with the observable ABX index for its year end financial statements, as these statements presumably would be subjected to a much higher level of audit scrutiny than the quarterly (*i.e.* August 31, 2007) statements.

353. The Company violated SFAS No. 115 and SFAS No. 157 by not valuing its CDS positions based on current market conditions and the ABX Index as of August 31, 2007. Similar to what the 2004 SEC order found, Morgan ignored current values, thereby foregoing requisite write-downs, and instead valued financial instruments based upon a market turn-around in late 2007. Well into 2008, the market has yet to turn around, and asset values have continued to plummet.

E. <u>Morgan Stanley Violated GAAP in Failing to Disclose Adequately its Subprime Positions</u>

354. As with their propensity to utilize disingenuous valuation methodologies to manipulate Morgan's reported results, Defendants also had a track record of inadequate disclosures to shareholders of their high risk subprime trading strategies and associated losses. This is evident from correspondence from the SEC admonishing Morgan Stanley for inadequate disclosure relating to this exposure dating back to the filing of its November 30, 2006 financial statements.

355. After the SEC took exception to the lack of subprime disclosure as set forth in a letter dated August 30, 2007, Morgan Stanley did not increase its level of disclosures in the financials for the Third Quarter 2007 Form 10-Q filed on October 10, 2007, despite the purported recognition of $1.9 billion in losses on its mezzanine CDS positions during the quarter, which was

not disclosed until November 7, 2007.

356. Furthermore, the Company's 2007 interim financial statements for the Second and Third Quarters, filed July 10, 2007 and October 10, 2007, respectively, lacked the required GAAP disclosures regarding the Company's significant concentration in subprime-related securities. In fact, in the Company's Form 10-Q filed on July 10, 2007, there was no reference to the word "subprime or sub-prime" included within the entire filing at all. The Form 10-Q filed on October 10, 2007, (some 40 days after the SEC reprimand letter) contained only limited references to the term "subprime" that appeared in the MD&A without reference to Company trading strategies, exposure or positions held.

357. Only 28 days later, Morgan Stanley issued a Form 8-K on November 7, 2007, disclosing for the first time its faltering subprime positions and further disclosing a related $3.7 billion write-down for the two months ended October 31, 2007. Along with these initial disclosures was the disclaimer by the Company that "these exposures will frequently change and could further deteriorate." The "Subprime Analysis" included as part of the Form 8-K included disclosure that as of August 31, 2007, the Company had continuing net exposure from its subprime positions of $10.4 billion. This huge exposure was never mentioned in the Second Quarterly 2007 financial statements, or the Third Quarter 2007 financial statements, which were filed on October 10, 2007, just 27 days before the November 7, 2007 loss announcement. Also, for the period ended October 31, 2007, $7.8 billion of the Company's $10.4 subprime exposure was recorded as write-downs in the Fourth Quarter; yet as of the filing of the Third Quarter financial statements, the Company's investors were not even aware that this exposure existed.

F. <u>Failure to Comply With Other GAAP Disclosure Requirements</u>

358. SOP No. 94-6, *Disclosure of Certain Risks and Uncertainties* ("SOP 94-6") requires disclosures to be made in financial statements regarding any vulnerabilities arising due to the fact that the business is exposed to certain risks and uncertainties that might have a "severe impact" on its future operations. SOP 94-6 defines a "severe impact" as a "significant financially disruptive effect on the normal functioning of the entity." SOP 94-6 requires, among other things, disclosure existing as of the date of those statements regarding the following:

a. Nature of operations

b. Use of estimates in the preparation of financial statements

c. Certain significant estimates

a. Current vulnerability due to certain concentrations

359. At the end of the Third Quarter 2007, Morgan had remaining net exposure relating to its subprime positions of $10.4 billion; yet the Company violated GAAP by failing to disclose this significant exposure in the related SEC filings for that period. During the Fourth Quarter 2007, the Company took a $7.8 billion write-down related to these subprime positions. This write-down caused the Company to record pre-tax and net losses of ($5.8 billion) and ($3.6 billion), respectively, for the quarter.

360. With respect to disclosures of an entity's vulnerability due to certain concentrations, SOP 94-6 indicates:

> Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.
>
> Financial statements should disclose the concentrations described in [subsequent paragraph] if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:
>
> a. The concentration exists at the date of the financial statements.
>
> b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
>
> c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.
>
> Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of [preceding paragraph]. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.
>
> a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this SOP, it

> is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.
>
> b. Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
>
> c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
>
> d. Concentrations in the market or geographic area [footnote omitted] in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

361. Further, the Company's significant concentration in subprime-related securities represented a material contingency which was required to be disclosed in the Company's condensed interim financial statements. APB No. 28, Interim Financial Reporting ("APB 28), states:

> Contingencies and other uncertainties that could be expected to affect the fairness of presentation of financial data at an interim date should be disclosed in interim reports in the same manner required for annual reports. Such disclosures should be repeated in interim and annual reports until the contingencies have been removed, resolved, or have become immaterial. (Footnote omitted.)

362. With respect to the mezzanine CDS derivative positions which accounted for the majority of the loss recorded by Morgan Stanley during the third and fourth quarters of 2007, MS violated SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* which requires that, for derivative instruments not designated as hedging instruments, disclosure shall indicate the purpose of the derivative activity. Defendants failed to disclose the purpose of the mezzanine CDS positions until the December 19, 2007 Earnings Conference call, at which time the Company's subprime trading strategy was cryptically disclosed. By that point, however, it was too late for investors, as $7.8 billion in write-downs had already been recognized.

363. Additionally, the Company violated the disclosure requirements of SFAS No. 5 and FIN No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including*

Indirect Guarantees of Indebtedness of Others. SFAS No. 5 requires disclosure of the nature of a loss accrual made pursuant to the standard not to be misleading. FIN No. 45 reinforces that guarantees accounted for as derivatives under SFAS No. 133 have remained subject to the disclosure provisions in of SFAS No. 5, and the disclosures required in this Interpretation are meant to provide users of financial statements with more detailed and useful information about guarantees that are accounted for as derivatives. If, as the November 7, 2007 press release implied, the Third Quarter Form 10-Q filed on October 10, 2007, contained undisclosed write-downs of $1.9 billion related to the subprime positions, detailed disclosure of the nature of the amount and source of the write-down in the Third Quarter Form 10-Q was required by this GAAP standard.

G. <u>Defendants Failed to Maintain Adequate Disclosure Controls and Procedures and Internal Controls over Financial Reporting</u>

364. In the SEC imposed cease-and-desist order against the Company discussed earlier, the SEC found that Morgan had overvalued certain high-yield bonds and aircraft assets by failing to properly value theses assets as of the current measurement dates. As part of this order, the SEC also concluded that Morgan's internal controls failed to ensure that its assets were valued in accordance with GAAP and that certain recordkeeping requirements were violated. The same violations exist with the Company's failure to value its CDS positions in accordance with GAAP.

365. Morgan Stanley's internal controls failed to ensure that material assets and liabilities were valued in accordance with GAAP. These materially deficient internal controls allowed Morgan to issue financial statements that were materially false and misleading and not in accordance with GAAP. The SEC defines "disclosure controls and procedures" as controls and other procedures of an issuer that are designed to ensure:

> that information required to be disclosed by the issuer in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarized and reported, with the time periods specified in the Commissions rules and forms...

366. Internal control over financial reporting is defined in Public Company Accounting Oversight Board ("PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* ("AS 2"), as follows, in relevant part:

> A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
>
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

367. Exchange Act Rules 13a-14 and 15d-14 require the Company's principal executive officer and principal financial officer to quarterly and annually certify the effectiveness of the Company's disclosure controls and procedures as of an assessment date within 90 days prior to the filing date of the report. Further, the Company is required to annually report on the effectiveness of its internal control over financial reporting. AS 2 states, in relevant part:

> A company subject to the reporting requirements of the Securities Exchange Act of 1934 (an "issuer) is required to include in its annual report a report of management on the company' s internal control over financial reporting ... The report of management is required to contain management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company' s internal control over financial reporting is effective....

368. During the Class Period, Defendants misled investors regarding the effectiveness of the Company's disclosure controls and procedures, and internal control over financial reporting. Defendants Mack and Sidwell falsely represented that the Company "maintained effective internal control over financial reporting."

369. The Company's disclosure controls and procedures, and internal control over financial reporting were not effective throughout the Class Period. Defendants deliberately and recklessly misstated Morgan Stanley's exposure to subprime-related positions. As a result of

Defendants' failure to maintain effective disclosure controls and procedures and internal control over financial reporting, Morgan Stanley was not only able to delay recognizing material losses on its subprime-related positions, but also was able to avoid even disclosing that the Company had a massive subprime exposure, in violation of GAAP.

370. The Company's true financial condition and results of operations were further masked with false reassurances that the Company had an effective risk management process and adequate disclosures. Defendants' statements regarding the effectiveness of the Company's disclosure controls and procedures and internal control over financial reporting, and more specifically, the management and disclosure of risk, were materially false and misleading for the reasons set forth above.

XI. ADDITIONAL SCIENTER ALLEGATIONS

A. General Allegations of Scienter

371. Defendants Mack, Cruz, Daula, Sidwell and Kelleher, by virtue of their receipt of information reflecting the improper and fraudulent conduct described above and/or their failure to review information they had a duty to monitor, their actual issuance of materially false and misleading statements or their control over Morgan's materially false and misleading statements, and their associations with Morgan and each other, which made them privy to confidential proprietary information concerning Morgan, were active, culpable, and primary participants in the fraudulent scheme alleged herein. Defendants Mack, Cruz, Daula, Sidwell and Kelleher knew or recklessly disregarded the materially false and misleading nature of the information they caused to be disseminated to the investing public.

372. Defendants Mack, Cruz, Daula, Sidwell and Kelleher also knew or recklessly disregarded that the materially false and misleading statements and omissions contained in Morgan's public statements would adversely affect the integrity of the market for Morgan's common stock and would cause the price of Morgan's common stock to be artificially inflated. Defendants Mack, Cruz, Daula, Sidwell and Kelleher acted knowingly or in such a reckless manner as to constitute a fraud and deceit upon Plaintiffs and other members of the Class.

373. In addition to the foregoing allegations, the following facts support a strong

inference that Morgan and Defendants Mack, Cruz, Daula, Sidwell and Kelleher knew or recklessly disregarded that the challenged statements set forth herein were materially false and misleading when made.

374. Each of these Defendants was keenly aware of the deteriorating conditions in the U.S. subprime mortgage market and the effect of these conditions on the value of securities linked to these mortgages. As a consequence of the acquisition of Saxon Capital in December 2006, the collapse of numerous subprime mortgage originators in the first and second quarters of 2007 and the demise of banks and hedge funds whose strategies were based on capitalizing on mortgage backed securities, the Defendants knew that the mortgage market was under intense scrutiny by investors and that Morgan's exposures to the subprime market were key areas in which the investment community was focused. In fact, Defendants lied when asked direct questions about risk management and subprime exposure.

375. Defendants knew or recklessly disregarded, that the Company had billions of dollars of exposure to subprime mortgage defaults as a result of the CDS trading positions assumed by the Proprietary Trading Group by no later than May 2007, prior to the start of the Class Period, according to Zoe Cruz's own admissions. By no later than early July 2007, each of these Defendants knew or recklessly disregarded that a stress test commissioned by Defendant Cruz had demonstrated the potential catastrophic consequences of the Morgan's exposure to CDSs referencing subprime securities to the tune of $3.5 billion.

376. By August 2007, each of the Defendants either knew or recklessly disregarded that the Company's risk controls relating to the pricing and reporting of the Company's exposures to subprime were deficient, based on the "vocal" concerns expressed by Defendant Daula. Moreover, each of the Defendants were aware of or recklessly disregarded the SEC's request for greater clarity and transparency of the Company's U.S. subprime exposures by virtue of the letter directed to Defendant Sidwell on August 30, 2007.

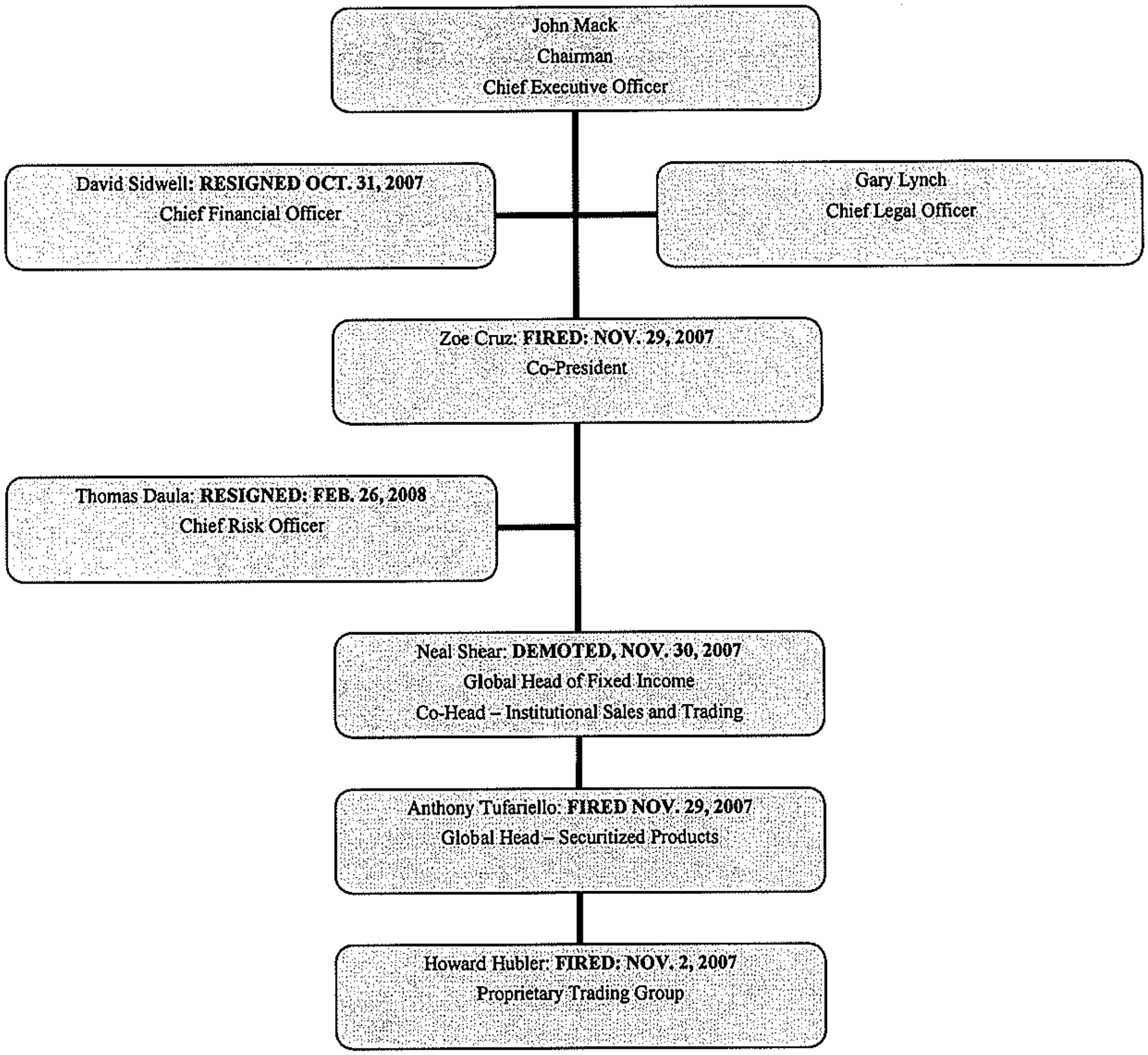
377. Each of the Defendants either knew or recklessly disregarded that the Company's disclosures relating to subprime were wholly misleading and that there were billions of dollars in subprime exposure on the Company's balance sheet based on the intentional implementation of

alternative Level 3 valuation inputs to assign a more favorable fair value to the Proprietary Trading Group's CDS position, as reported in the Company's earnings conference call on September 19, 2007, and repeated in the Company's Third Quarter 2007 Form 10-Q.

378. The knowledge and/or extreme recklessness of the Defendants is evident also from their rapid firings and resignations following the disclosure to shareholders of the massive losses that Morgan would take. John Mack said on the earnings conference call on December 19, 2007, "the results we announced today are embarrassing for me, for our firm, this loss was the result of an error in judgment that occurred on one desk, in our Fixed Income area, and also a failure to manage that risk appropriately. Make no mistake, we've held people accountable. We're moving aggressively to make the necessary changes."

379. Indeed, while avoiding his own responsibility, Mack did indeed make changes by eliminating the persons whose failures, he pegged, for being directly responsible for Plaintiffs' losses, other than himself. The initial scapegoat was Howard Hubler who was fired on November 2, 2007. The recriminations continued as Morgan was forced to come clean about the scale of the losses. On November 30, 2007, Anthony Tufariello, Hubler's immediate supervisor, was fired. Zoe Cruz, was fired on November 29, 2007 as well. On that day, Neal Shear, once the second highest paid individual at the Company, was demoted; he would later resign in March 2008. David Sidwell, who had announced that he would retire at the end of the financial year, resigned early, on October 31, 2007, leaving Colm Kelleher, in his first appearance as CFO, to face angry investors about the Company's losses. Finally, the news that Thomas Daula would also be departing the Company was leaked on February 20, 2008, after the filing of the Company's 2007 Form 10-K, and Daula resigned in March 2008.

380. The chart below shows the individuals who were fired, demoted, or resigned in connection with the Company's disclosures of its losses:



381. Defendants Morgan, Mack and Sidwell also knew or recklessly disregarded that during the Class Period the Company had announced and was issuing to the public $1 billion worth of Fixed Rate Senior Notes ("Senior Notes") on or about October 30, 2007, which was one week prior to Defendants' disclosure of massive losses from U.S. subprime bets. Defendants Mack and Sidwell had signed the Registration Statement for the Shelf Offering related to these Notes, and they were aware or recklessly disregarded that the Company had issued an amended Prospectus on July 24, 2007 and a pricing supplement on October 30, 2007 to issue the Notes to investors. When the Notes were publicly issued in late October 2007, the Company and Mack and Sidwell knew or recklessly disregarded that Morgan's true financial condition and prospects had not been fairly presented in the Company's SEC filings, which were incorporated by reference into the Registration Statement and Prospectuses for the Notes. Morgan, Mack and Sidwell deliberately and recklessly

failed to update the financial condition and prospects of the Company prior to the Notes being offered because they wanted to raise approximately $1 billion through the Note offering before news of Morgan's massive subprime-related losses were disclosed to the public and to ratings agencies that had rated the Notes as "Aa3".

B. John Mack

382. Defendant Mack participated in the issuance of, signed and certified as accurate and complete as required by Sarbanes-Oxley, the Company's materially false and misleading SEC filings issued during the Class Period including, *inter alia*, the Company's Second and Third Quarter Form 10-Qs filed with the SEC. Throughout the Class Period, Defendant Mack also made a number of materially false and misleading statements regarding the Company's subprime exposure as well as the effectiveness of its risk monitoring procedures.

383. Morgan's acquisition and aggressive trading of risky subprime assets was fostered by Mack who implemented a business strategy that granted the "trader's option" to the Proprietary Trading Group and deliberately steered the Company to assume higher levels of risk. While the Company was increasing its exposure to risk, it was doing so without effective policies and controls to ensure that the Company's exposure of risk was accurately communicated to its investors in direct contrast to its public statements.

384. While Defendants told shareholders and investors that Morgan's growth and concomitant expanding risk was "disciplined and balanced," Mack actively changed the risk reporting structure within the Company. Specifically, in October 2005, Mack surreptitiously altered Defendant Daula's reporting line so that he reported directly to Mack's hand-picked Company Co-President and head of trading, Zoe Cruz, notwithstanding that Cruz's colleagues had panned her as recklessly assuming or disregarding risk. *See supra* Hagan ("'I'd be more than happy for Zoe [Cruz] to take more risk,' Pandit told a friend, 'if I felt comfortable that she understood the risk she'd be taking.'"). Further, Mack knew or was reckless in disregarding the fact that his alteration to the Company's risk controls was counter to the industry standard that risk control personnel's reporting chain should be independent of the business line.

385. Defendant Mack's reckless decision to have the chief risk manager report to the

same group trading manager has since been reversed. After the Company reported its $9.4 billion loss in Fourth Quarter 2007, Defendant Mack changed the ranks to require Morgan's Chief Risk Officer, Defendant Daula, to report to the CFO, instead of to the head of trading.

386. In an April 21, 2007 Shareholder Meeting, Defendant Mack singled out Cruz (and Daula) as being responsible for managing Morgan's risk exposure and reassured investors that Cruz and Daula's management of the Company's risk exposure boded well for the Company and investors. Thus, while Mack was encouraging Morgan to increase its risk appetite—while assuring investors that Morgan's risk assessment tools were effective – he deliberately altered the reporting structure to place a manager with debilitating conflicts of interest (as Cruz's compensation was based on the performance of ISG) in charge of ensuring that the Company complied with its stated risk exposure policies. Cruz effectively held sole authority for managing risks of trades that she was approving; thus, unbeknownst to shareholders and traders, the Company had no risk controls for a trading desk that was engaging in aggressive, high-risk trades that ultimately "bet the Company."

387. Defendant Mack's willingness to recklessly amass risk initially paid dividends as ISG reported record results throughout fiscal 2006, and through the first two quarter of fiscal 2007. The Company's positive statements about its ability to manage risk continued into the first and second quarters of 2007 which led to, *inter alia*, credit upgrades from S&P, which were based on Morgan's purported ability to distinguish itself from its Wall Street peers as problems continually erupted from the ongoing collapse of the subprime market.

388. However, while Mack and Morgan were touting the Company's disciplined growth, by at least May 2007, by her own admission, Cruz became aware of the potential catastrophic exposure Morgan faced by a collapse of the housing/credit markets. When (by July 2007) the results of Cruz's requested stress test results demonstrated that the Company could lose $3.5 billion from its subprime related exposure, such that she ordered the CDS position cut, disclosure of this potential subprime-related loss could have cost the Company a ratings downgrade from rating agencies thereby forcing the Company to raise hundreds of millions of dollars in additional capital. During the Third and Fourth Quarter 2007, the credit markets were tightening and panic was

ensuing as Wall Street titans like Citigroup and Merrill Lynch reported declines in profits and huge multi-billion-dollar losses from bad bets on securities underpinned by subprime mortgages.

389. Throughout most of fiscal 2007, until November 7, 2007, Defendant Mack and other Defendants deliberately and recklessly stated and implied that Morgan had largely skirted subprime mortgage losses that plagued the Company's rivals. Mack stood by silently as CEOs of Morgan's rival Wall Street companies were being ousted. Mack knew that cash was king as capital suddenly was hard to come by – even for Wall Street stalwarts like Morgan, and earnings volatility and ratings downgrades would have materially impaired Morgan's ability to operate.

390. As disclosed by the Company in its Third Quarter 2007 Form 10-Q, a one-notch downgrade by the Rating Agencies would have materially disrupted the Company's operations and would have required the Company to post an additional $588 million in collateral to counterparties. By deliberately failing to mark to market and record losses on its risky CDS positions and deliberately and recklessly avoiding disclosure of Morgan's multi-billion dollar subprime exposure, Mack quietly was able to negotiate a $5 billion capital infusion from China's CIC that prevented a capital void that would have severely disrupted the Company's ability to operate in the already roiling credit markets.

391. Cruz's stress test, demonstrating the potential debilitating effect of the CDS positions (that she approved), was not the only piece of information that Mack had access to regarding the Company's ensuing financial crisis during the Class Period. In a letter dated August 20, 2007, the SEC informed Defendants that Morgan's subprime-related disclosures were insufficient. Moreover, by August 2007, Daula – who was touted by Mack as being "one of the best overall risk managers" – was "vocally" warning Defendants that the pricing models used by Morgan to value assets were flawed and were not producing accurate results. Mack, along with the other Defendants, managed the day-to-day affairs of the Company through his CEO responsibilities and participation on Morgan's management committee. As reported in *The Wall Street Journal*, Mack also had been attending weekly risk-assessment meetings at least by October 2007 regarding "rumblings" of the Company's "$7.8 billion fourth-quarter write-down tied to bad CDO bets." Hagan's article in *New York Magazine* also stated that Mack got more directly involved, leading risk-management

meetings and investigating what went wrong as the impending losses from the CDS positions were growing. Moreover, during the December 19, 2007 conference call, Mack essentially admitted that the risks taken by the "one desk" with the subprime-related CDS positions were material to investors, and were taken with his knowledge, when he stated that, going forward, "I'm going to be and this firm is going to be much more cautious in some of these larger bets."

392. Despite all of the following: 1) receipt of the SEC's letter demanding additional subprime-related disclosures; 2) critical deterioration in the credit markets; 3) enormous reported subprime-related losses from Morgan's Wall Street peers; 4) participation in weekly credit assessment meetings regarding the multi-billion dollar Fourth Quarter 2007 write-down; 5) Daula's warnings and the reports of stagnated losses as demonstrated by Cruz's stress test; and 6) knowledge or reckless disregard of growing illiquidity from tightening credit markets; Mack publicly disclosed nothing about the extent of the Company's massive subprime exposure until unavoidable billions in write-downs could no longer be concealed because of leaks in the market regarding the CDS positions and the continuing demise of the subprime and credit markets, and most importantly, the continuing substantial decline in the ABX index.

393. Defendant Mack certified both the Second Quarter 2007 Form 10-Q and the Third Quarter 2007 Form 10-Q and knowingly and recklessly stated that the Company's internal controls had no material weaknesses and that each of the 10-Qs "fairly presents, in all material respects, the financial condition and results of operations of the Company."

394. Further, Morgan's attempt to paint its November 7, 2007, write-down as the result of a sudden realization that its U.S. subprime liabilities suddenly materialized is completely undermined by Cruz's actions beginning in May (unwinding some subprime positions and ordering a stress test on others) and continuing through the summer of 2007. Throughout the Class Period, Mack knew or recklessly disregarded that the overall impression created by Morgan's financial statements and earnings reports were not consistent with the business realities of the Company's financial condition and prospects. Moreover, for each of the 10-Qs for the second and third quarters of 2007, Mack signed a "Rule 13A-14(A) Certification of Chief Executive Officer," which was filed with the 10-Q, in which he certified that, along with Sidwell, he had "designed such disclosure

controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, **to ensure that material information relating to the registrant**, including its consolidated subsidiaries, **is made known to us by others within those entities, particularly during the period in which this report is being prepared.**" (Emphases added).

395. Mack had strong incentives – both economic and reputational -- to manipulate Morgan's true financial condition as his compensation was directly tied to the Company's performance. The majority of Mack's compensation was directly tied to the Company's performance through an incentive bonus that depended upon Morgan's performance. Mack's annual salary was $800,000, but over 98% of his compensation was received in year-end bonuses (restricted stock units and stock options) that depended upon Mack's performance and the Company's performance and progress towards its strategic goals. Mack held the distinction in years past as having received "the largest bonus awarded to a Wall Street CEO," as reported in USA TODAY, December 15, 2006.

396. Mack had publicly announced in 2005 the goal of doubling Morgan's pre-tax profits in five years and committed to substantially growing income and earnings by balancing a deliberate increased risk appetite for aggressive proprietary trading with increased risk controls. Mack knew or recklessly disregarded and liabilities resulting from multi-billion-dollar, high-risk CDS positions deliberately were not properly valued in accordance with GAAP so that the Company could meet analyst expectations during the Class Period. Defendant Mack and the other defendants recklessly hoped – against clear moribund signals -- that the subprime and CDO markets would rebound and that they could unwind Morgan's CDS positions, or buy time to find an investor to shore up the Company's capital needs.

C. David Sidwell

397. As Morgan's CFO, Defendant Sidwell participated in the issuance of, signed and certified the Company's materially false and misleading SEC filings as accurate and complete, as required by Sarbanes-Oxley. During the Class Period, Sidwell signed and certified the Company's Second and Third Quarter Form 10-Qs filed with the SEC, and throughout the Class Period, Sidwell conducted quarterly earnings conference calls with shareholders and investors and made a number

of materially false and misleading statements regarding the Company's subprime exposure as well as its risk-monitoring infrastructure.

398. As the Company's CFO, Sidwell was in charge of monitoring the Company's internal controls and reporting Morgan's risks, including the undisclosed adverse billion-dollar CDS positions during the Class Period. Sidwell assumed his CFO role at Morgan in March 2004, and therefore, he was keenly aware of Morgan's agreement to enter in the Cease and Desist Order with the SEC in November 2004, in which the Company agreed to cease and desist from committing or causing any future violations of the Exchange Act by maintaining adequate controls to ensure that Morgan valued its positions in accordance with GAAP and accurately stated its positions in the Company's books and records.

399. In an investment bank, it is part of the CFO's job to know what securities the company has in terms of its proprietary trading, because the CFO is responsible for obtaining the financing to purchase those securities. Therefore, Sidwell could not have been ignorant about the existence, size and nature of the CDS's without having been reckless in his ignorance.

400. Having singled out and publicly discussed during the September 19, 2007 conference call, the transfer of what we now know was the CDSs from Level 2 to Level 3, Sidwell either knew or was extremely reckless in not knowing that the reason that the fair value category of the CDSs was being changed, that the fair value of these CDSs was based on the ABX Index, and that they were *not* being recorded at fair value.

401. In addition to his years of experience as Morgan's CFO, Sidwell had 20 years of extensive experience as the former CFO of the investment bank division of JPMorgan Chase and as Controller of its predecessor, JP Morgan. Prior to his experience at JPMorgan Chase, Sidwell spent nine years with the public accounting firm, Pricewaterhouse Coopers, and he had served as a trustee of the International Accounting Standards Committee Foundation and was a member and Chair of the SEC Committee on Corporate Reporting of Financial Executives International. He also had in the past been a committee member of an advisory council of Emerging Issues Task Force of FASB. Sidwell also was tapped in October 2007 to be a member of the SEC Advisory Committee on Improvements to Financial Reporting. Defendant Sidwell drew upon his numerous years of

expertise in GAAP and financial reporting to guide Morgan through its adoption of Fair Value reporting in accordance with SFAS 157 in December 2006. Therefore, he was acutely aware of the Fair Value reporting requirements and had purportedly implemented them at the Company. During the Class Period, Sidwell knowingly and recklessly caused Morgan to issue and file financial statements and reports with the SEC that stated that the Company had implemented SFAS 157 and had prepared its financial statements in accordance with SFAS 157, when he knew or recklessly disregarded that Defendants had not complied with SFAS 157 for the Company's risky multi-billion-dollar bet on subprime-related securities.

402. Sidwell also served on Morgan's Management Committee through which he and other high-level executives, including Defendants Mack, Cruz and Daula, oversaw and controlled the Company's day-to-day activities and had ultimate responsibility for the control function over trading activities.

403. Even prior to the Class Period, Sidwell assured investors that Morgan was increasing its risk taking endeavors in a "disciplined and balanced way." Analysts seized on Sidwell's representations and touted the Company's success as based, in part, on "gradual[] increase" in the amount of trading risk. Moreover, in reporting earnings for the First Quarter 2007, Sidwell assured investors that while subprime had been a key focus in the market during early March 2007, the Company had managed its risk through a variety of hedging strategies and proprietary risk positions that had significantly contributed to Morgan Stanley's record trading results and income. The record income from First Quarter 2007 and further gains from subprime bets on CDSs were carried forward in Second Quarter and Third Quarter fiscal 2007 earnings reports, without additional necessary disclosures that related bets had soured and were projected to reverse course for record earnings and cause a record loss.

404. Sidwell also falsely assured investors that the Company had decreased Morgan's risk exposure in early 2007 to balance Morgan Stanley's level of risk with Defendants' view of potential market changes. This was all part of the total mix of information regarding Morgan Stanley leading into the Class Period. However, once the Class Period began, Sidwell knew or deliberately and recklessly disregarded that the Proprietary Trading Group's CDS positions had exposed the

Company to billions of dollars in losses because he participated on the Company's Management Committee along with Defendant Daula, the Company's CRO. As confirmed by CW 5, Controllers created daily summaries of trading positions and marks from the Company's traders that were provided up the channel of authority at Morgan to Daula and Sidwell and other managers.

405. Sidwell knowingly and recklessly made material misrepresentations concerning the Company's ability to weather the subprime meltdown during the Class Period. Indeed, at the beginning of the Class Period, during a June 20, 2007 Second Quarter earnings call with analysts, Sidwell served as the spokesperson for the Company assured the market that the Company "certainly did not lose money in [the subprime] business" during the second quarter of 2007. Sidwell's comments were made after Cruz (starting in May 2007) began cutting, and selectively advising Morgan customers to eliminate, subprime-related positions and had ordered Daula to conduct a stress test on Morgan's positions. Sidwell was familiar with the Company's stress testing, and he commented on the Second Quarter 2007 earnings call that stress testing scenarios helped him and others "manage less liquid risk" as the Company had increased risk exposure during the latter half of Second Quarter to "balance the level of risk with our view of market opportunities…."

406. Thus, while Sidwell was assuring analysts and the market that the Company had not suffered from any marks in the mortgage area from "betting the wrong way" and "did not lose money in [the subprime] business," Morgan executives (including Cruz) were simultaneously trying to unwind the Company's exposure to subprime losses and had ordered an analysis of the Company's subprime exposure, including the Proprietary Trading Group's big bet on subprime-related CDSs. Sidwell made no mention of these facts, or the Company's multi-billion-dollar exposure resulting from risky subprime CDS positions on the Second Quarter 2007 earnings conference call.

407. Further, the SEC's August 30, 2007 letter to Sidwell put him and the Company on further notice that the SEC considered Morgan's disclosures about its subprime exposure to be inadequate. Moreover, an article appearing in the *Financial Times* (on December 21, 2007) disclosed that "[b]y August [2007], Mr. Daula was very vocal in saying that there were no proper

pricing models for [subprime related] . . . trades, that positions were not being properly measured, and that the history traders used in their models was not a reliable guide." Despite the SEC's direct request to Sidwell for more transparency and Daula's "vocal" warnings, Morgan's Third Quarter 10-Q (filed 40 days after the SEC's letter was issued) – which was signed by Sidwell – failed to provide investors with any detail concerning: i) Morgan's exposure to potentially unavoidable multi-billion-dollar losses from the Global Proprietary Group's trade; ii) Cruz's frantic divestment of subprime-related exposure beginning in May; iii) the results of Cruz's stress test; or iv) Daula's warnings.

408. Rather than increase Morgan's transparency, after receiving the SEC letter, Sidwell knew or recklessly disregarded that the Company was attempting to conceal fair value losses on Morgan's subprime exposures by using Level 3 inputs to arrive at more favorable valuations, when the Level 2 inputs that had been used all along yielded unacceptable losses. The use of those Level 3 inputs over Level 2 inputs – which violated GAAP – was motivated not only by Sidwell's desire to conceal losses from the Proprietary Trading Group's trade but also by earnings expectations for the Company. The Company reported financial figures just barely within Wall Street's expected range solely by using Level 3 inputs to value the CDS position and ignoring inputs from the ABX Index. Without the manipulation of fair value and deliberate disassociation of the CDS positions from the ABX Index, Morgan would have been forced to record $4.4 billion of losses on the CDS positions, would have missed its earnings targets by a large margin and would have reported a loss for the first time in the Company's history.

409. Defendants failed to respond timely to the SEC's request for additional subprime disclosures, until November 27, 2007 (after Sidwell had retired) and well after the Company had begun to publicly disclose the aggressive multi-billion-dollar CDO subprime bet that had exposed the Company and its investors to billions in losses.

410. During the Third Quarter 2007 Conference Call, Sidwell falsely stated that his "goal" for the call was "to be as clear as possible" as to how the "many challenging market dynamics" had impacted Morgan's results. Sidwell acknowledged that the credit markets had deteriorated considerably during the course of the Company's Third Quarter and that "increased

volatility, significant spread widening, lower levels of liquidity, and reduced price transparency at all parts of the capital structure" had affected lending markets, the effectiveness of hedging strategies, subprime mortgage markets, including the CDS market, and other structured credit products. He further stated that the "credit environment" had significantly impacted Morgan's results in lending and credit sales and trading. Sidwell provided granular detail of how markdowns to loans and commitments had led to approximately $940 million in mark-to-market losses during the quarter and that EPS from such losses was approximately $0.33 per share. He also gave details regarding $480 million in other losses, but he deliberately and recklessly failed to mention that Defendants' mark-to-market of the subprime-related CDS position had generated **$1.9 billion** in *recognized* losses during Third Quarter.

411. On the Third Quarter 2007 earnings conference call, Sidwell knowingly and recklessly omitted any reference to: i) reclassification of subprime-related CDS liabilities from Level 2 to Level 3; ii) the subprime-related exposure to billions of dollars in losses; or iii) the devastating results of Cruz's stress test. He further deliberately omitted to reference the true motivation behind the improper reclassification of assets and liabilities, which was to meet earnings projections and allow the Company to quietly obtain a capital infusion before blasting shareholders and investors with news of billions in losses from risky subprime CDS bets.

412. Sidwell falsely and recklessly stated that the Company's "assets and liabilities are recorded at fair value." Sidwell also publicly claimed that Defendants used ***observable*** market data to value its assets and liabilities, which he knew was materially false and misleading as he and other Defendants knowingly and recklessly failed to record the $13.2 billion long CDS position at fair value as dictated by the decline in the benchmark ABX indices, which was the most significant observable input to value the CDS positions in Third Quarter 2007.

413. Although providing detailed information on the conference call regarding the percentage of assets and liabilities classified as Level 2 and Level 3, and stating that liabilities in Level 3 had increased to approximately 3% of total liabilities, as compared to 2% in Second Quarter 2007, Sidwell knowingly and recklessly did not disclose that the increase in Level 3 liabilities was in connection with the Proprietary Trading Group's CDS position and that the increase in Level 3

liabilities and purported "fair" valuation related to the undisclosed $1.9 loss mark-to-market loss; thereby rendering these statements materially false and misleading as well. Sidwell also falsely stated that the major components of Level 3 are the "same" as disclosed in Second Quarter 2007. The magnitude and nature of the undisclosed $1.9 billion write-down and contemporaneous reclassification of billions of dollars of related subprime liabilities, especially in light of Sidwell's other disclosures on the conference call and in the Form 10-Q, demonstrates that Sidwell's omissions of material information regarding the CDS positions were deliberate and were made to create an overall impression that was not consistent with the business realities of the Company's financial condition and prospects. Moreover, for each of the 10-Qs for the second and third quarters of 2007, Sidwell signed a "Rule 13A-14(A) Certification of Chief Financial Officer," which was filed with the 10-Q, in which he certified that, along with Mack, he had "designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, **to ensure that material information relating to the registrant**, including its consolidated subsidiaries, **is made known to us by others within those entities, particularly during the period in which this report is being prepared.**" (Emphases added).

414. Defendant Sidwell also certified both the Second Quarter 2007 Form 10-Q and the Third Quarter 2007 Form 10-Q, as required by Sarbanes-Oxley, and knowingly and recklessly falsely confirmed that the Company's internal controls had no material weaknesses and that each of the 10-Qs "fairly presents, in all material respects, the financial condition and results of operations of the Company." Sidwell knew or recklessly disregarded that these statements and certifications were materially false and misleading when made.

415. Sidwell directly benefited from misrepresenting Morgan's true financial condition. His compensation was tied to the Company's performance, and although Sidwell had announced his intention to resign effective at fiscal 2007 year end, he relinquished his CFO position on October 11, 2007, which was the day after the Third Quarter 2007 Form 10-Q was filed with the SEC. Sidwell retired from employment with Morgan on October 31, 2007, according to Morgan's 2008 Proxy (filed with the SEC on February 27, 2008). Therefore, Morgan's compensation committee considered only his and the Company's performance for the first three quarters of the fiscal year

2007 in deciding Sidwell's bonus. Based on Sidwell's "helping develop the Company's strategic growth plan and communicating it to the investment community" during the first three quarters of fiscal 2007, Morgan's compensation committee awarded Sidwell a bonus of ***$13 million***. Because Sidwell retired before the grant date of fiscal year-end incentive compensation, Sidwell was able to obtain his entire fiscal 2007 bonus in cash, instead of an equity award.

D. Zoe Cruz

416. While investors were being assured that Morgan Stanley's risk from subprime exposure was contained, as detailed in *New York Magazine*, in May 2007, Cruz claimed that she had personally become concerned about the Company's exposure to the entire mortgage business and subprime losses and began ordering the unwinding Morgan's mortgage-related exposure before the Class Period even began in May 2007. Cruz also claims to have informed some of Morgan's clients – but not Morgan's shareholders – of an impending collapse of the mortgage and housing markets and urged the Company's clients to exit positions to limit their exposure to mortgage related positions.

417. Cruz further acknowledged that her concerns led her to order Daula to run stress tests on the Proprietary Trading Group's positions at this same point in time. Cruz purportedly received the results of the stress test on July 4, 2007, according to her own account of the timing. At that time, Defendant Daula informed Cruz that the stress analysis suggested that Morgan could lose ***$3.5 billion*** on the Proprietary Trading Group's CDS positions.

418. Despite having specific knowledge of Morgan Stanley's multi-billion dollar exposure to subprime losses, Cruz kept quiet and allowed the Company to file its Second Quarter 2007 Form 10-Q with the SEC on July 10, 2007, without any disclosures regarding the CDS positions or potential subprime-related multi-billion-dollar losses or her order to Daula to cut the position. Moreover, less than one month ***after*** Cruz ordered the Proprietary Trading Group's CDS positions to be cut, Morgan Stanley held a conference call with analysts to discuss the Company's second quarter 2007 results. During the call, Sidwell, as the spokesperson for the Company, failed to mention the massive loss uncovered by the stress test ordered by Cruz weeks earlier. As a result, Cruz had actual knowledge that these statements were materially false and misleading when made.

419. On the Third Quarter 2007 conference call, Defendant Kelleher reported that an additional $2 billion in capital had been allocated to the ISG, which was under Cruz's control. Thus, while Cruz was ordering the Company to cut its exposure to subprime losses, Cruz knew that Morgan's investors were being led to believe that all was well within the Company. Cruz also knowingly and recklessly stood idly by as Morgan made material omissions in the Third Quarter 2007 earnings release and Third Quarter 2007 Form 10-Q regarding the Company's $1.9 billion write-down from the CDS positions – caused by the Proprietary Trading Group of the ISG division that she managed and controlled – or the Company's $10.4 billion subprime exposure.

420. Throughout the summer of 2007, Cruz "underplayed the extent of the losses [at Morgan]," although according to clients, she was very bearish on subprime and very concerned. *See supra* Hagan ("'Cruz was clearly a bear and clearly extremely concerned, and she called me every couple of weeks,' says one of her former clients, Stanley Druckenmiller, a veteran hedge-fund manager.").

421. Throughout the Class Period, Cruz received weekly updates from Daula on the Company's risk position and was well aware that Morgan's risk reporting structure was not publicly disclosed. Thus, setting aside any specific knowledge of defects in Morgan's risk assessment protocols and the Company's exposure to loss, Cruz's job responsibilities required her to be personally aware of material transactions within her department such as the massive bet placed on U.S. subprime by the Proprietary Trading Group. In addition, unbeknownst to investors, Defendant Daula, the Company's CRO, reported directly to Cruz. Cruz had unfettered access to this material adverse information at any time she wanted it. Cruz's specific knowledge of Morgan's subprime exposure (via the results of the stress test and Daula's reports) is corroborated not only by her own account of events, but also by external markets factors, such as the eroding ABX index, subprime losses by Morgan Stanley's peers, increasing defaults and a deteriorating housing market.

422. Also in July 2007, Cruz was aware or recklessly disregarded that credit rating downgrades and credit watch reviews for RMBS and ABS CDOs signaled that mezzanine and high-grade ABS CDO tranches were also going to be subject to downgrades and write-downs. Morgan Stanley's own analysts publicly projected in a July 16, 2007 research report that write-downs could

"bleed into parts of the A stack." Morgan's own report further stated that there had been 1,342 downgrades of subprime RMBS as of July 16, 2007, compared to only 36 such downgrades by Moody's in all of 2006. Thus, in addition to her own suspicions, Cruz had at her disposal and recklessly disregarded key indicators at the outset of the Class Period that the Proprietary Trading Group's big bet on subprime CDSs was ill fated and would cause imminent cataclysmic losses in her ISG division if marked to fair value as required by GAAP. These suspicions converted into actual knowledge by her own admission by no later than July 4, 2007. Cruz not only left the position in place after her orders to cut it were ignored, but she also knowingly and recklessly caused Morgan to disclose materially false and misleading reports regarding the financial results of the ISG and the management of increased high-risk trading to shareholders and investors.

423. Mack has since pinned Morgan's financial woes on Cruz. *See* "The colossus brought to its knees," *The Daily Mail*, Sept. 19, 2008 ("Then came the credit crunch. Morgan's lost $10 billion on the mortgage markets and critics called for him [Mack] to be sacked. Instead, ever ruthless, ***Mack blamed his chief henchman, Zoe Cruz 'Missile', and removed her instead.***") (emphasis added).

424. In addition to her actual knowledge of the fraudulent misstatements, Cruz was motivated to boost the Company's reported performance because the majority of her multi-million compensation was received in the form of year-end incentive compensation. Cruz also was motivated to misrepresent Morgan's true financial condition to avoid being fired, which is exactly what happened to her when the truth was revealed.

E. <u>Tom Daula</u>

425. As Morgan's Chief Risk Officer, Defendant Daula was responsible for all risk-related disclosures issued by the Company, including risk-related disclosures concerning Morgan's Proprietary Trading Group and the Company's proprietary trades. Daula was one of the chief spokespersons for assuring investors that Morgan risk monitoring exposure was adequate. For example, in a power point presentation by Daula to investors (dated February 14, 2006), titled "Risk Management at Morgan Stanley An Overview," Daula outlined the procedures Morgan supposedly had in place to monitor trading risks. Daula's presentation was intended to, and did in fact, assure

investors that the Company's growth was disciplined and within the bounds of acceptable risk.

426. Moreover, in an April 21, 2007 Shareholder Meeting, Mack singled out Daula (and Cruz) as being responsible for managing Morgan's risk exposure and reassured investors that Cruz and Daula's management of the Company's risk exposure boded well for the Company and investors. Thus, setting aside any specific knowledge of defects in Morgan's risk assessment protocols and the Company's exposure to loss, Daula's job responsibilities required him to ensure Morgan's risk assessment functions were sufficient, functioning properly and did not conflict with public disclosures being made about risk assessment protocols.

427. Notwithstanding Daula's responsibilities as Morgan's Chief Risk Officer, at the very outset of the Class Period and months before Defendants disclosed Morgan's massive subprime-related losses, Daula was personally aware that the Proprietary Trading Group's CDS positions potentially exposed the Company to ***$3.5 billion*** in losses as he himself had performed a stress test that Cruz had directed him to run in May 2007. Defendant Daula also provided weekly updates to Cruz on the Company's risk exposure, at least each week from July 4, 2007 until the end of the Class Period, and Daula had actual knowledge that Morgan's undisclosed subprime exposure had grown to $10.4 billion as of August 31, 2007.

428. Moreover, published reports revealed that beginning in August 2007, "Daula was very vocal in saying that there were no proper pricing models for [sub-prime related] . . . trades, that positions were not being properly measured, and that the history traders used in their models was not a reliable guide." Daula's concerns and the true dire state of the Company's internal controls and pricing models were not disclosed to investors during the Class Period as the Company falsely reported that risks were being taken in a balanced and disciplined manner. Daula served on the Company's management committee and had a duty to ensure that the Company accurately reported its financial results, condition and prospects, which Daula knew or recklessly disregarded, was not being done during the Class Period.

F. <u>Colm Kelleher</u>

429. Defendant Kelleher, assumed the role as Morgan's CFO on October 11, 2007, although he was not slated to take over the position until the end of fiscal 2007 (November 30,

2007) when Defendant Sidwell was supposed to resign. Sidwell relinquished the CFO position to Kelleher on October 11, 2007, which was the day after Morgan filed its materially false and misleading Third Quarter 2007 Form 10-Q with the SEC. Kelleher assumed the CFO position at a time of financial crisis at Morgan, and he made a number of materially false and misleading statements regarding Morgan's financial results and subprime exposure during the Class Period.

430. Kelleher also was a member of Morgan's Management Committee during the Class Period and participated in decisions and risk management at the highest levels of the Company. According to the Deutsche Bank analysts, Kelleher's background included fixed income sales and structuring and an early career with the accounting firm, Arthur Andersen. The analysts stressed that Kelleher, in expressing his philosophy of risk management, had stressed "that there cannot be valuation issues if there is going to be efficient risk management." He also stated that one of his first moves was to "find alternative means to prove valuations." Therefore, Kelleher also had the background that enabled him personally to understand that the CDS position at the end of Third Quarter 2007 was improperly valued in order to manage earnings and avoid reporting a loss.

431. Kelleher held meetings with analysts in October 2007, after which analysts at Deutsche Bank reported that they had taken away "comfort that the 3Q07 shortfall stemmed from bad execution vs. bad systems and that, with more normal markets, performance should mostly recover." They further reported that the Company's problems "were attributed less to risk control than to poor trading, a good portion of which should recover with better markets." Kelleher also apparently reported to the Deutsche Bank analysts that he had "shadowed the outgoing CFO for the past five months." Therefore, Defendant Kelleher acknowledged that he was privy to the information reviewed by Defendant Sidwell during the entire Class Period, including the false and misleading statements in the Second and Third Quarter 2007 Form 10-Qs and the accounting manipulations through which the CDS position improperly was valued after being reclassified to Level 3 from Level 2 to manage earnings and buy time for the Company to find a capital infusion.

432. Kelleher told the Deutsche Bank analysts that risk management had played out as expected during Third Quarter and "does not need changing." As a result, the analysts reported that "our read is that Morgan thought it more important to limit its losses than risk any more of its

earnings or capital during the August turmoil. If so, we feel a touch better about its risk management and slightly better that its results can improve more directly with better markets." Kelleher's statements to the analysts, which were repeated to the market at large as he knew and intended, were materially false and misleading and deliberately and recklessly misrepresented the losses and risk management systems at the Company, which as stated by Defendant Daula were riddled with problems from nonworking models and lack of ability to properly measure trading positions by no later than August 2007, several months ***before*** Kelleher made such statements.

433. In addition, Kelleher participated in the Company's Third Quarter 2007 earnings conference call and made a number of materially false and misleading statements. Defendants Kelleher and Sidwell volleyed coverage of the Company's financial performance back and forth during the call, and Kelleher falsely stated that Sidwell had "covered the primary drivers of the decrease" in revenue from fixed income sales and trading during Third Quarter, when in fact, Sidwell and Kelleher each knew and both failed to disclose the ***$1.9 billion*** write-down to the long CDS position during Third Quarter 2007. On the call, Kelleher and Sidwell provided granular detail regarding losses generated from mark-to-market loan commitments and related $940 million in losses and a $726 million write-down, which demonstrates that the exclusion of any information regarding the $1.9 billion write-down was deliberate and reckless.

434. Kelleher also told analysts during the Third Quarter 2007 earnings conference call that he was going to provide them with "enough analytic metrics to help [them] model future scenarios, based upon [their] overall market assumptions." Kelleher deliberately and recklessly failed to disclose the most significant metrics regarding the Company's $10.4 billion subprime exposure, and he falsely attributed the decrease in revenues from fixed income sales and trading to general, unspecified "market conditions."

435. On November 7, 2007, after Morgan announced a $3.7 billion decline in its subprime related assets, Kelleher held his first solo conference call with analysts during which he tried to present Morgan's loss as a surprise. Notwithstanding Kelleher's attempt to present the loss as unexpected, Kelleher and other Morgan senior executives (including the Individual Defendants) knew or recklessly disregarded as early as July 2007 that Morgan was exposed to billions of dollars

in subprime related losses. Kelleher also had participated in the Third Quarter 2007 earnings conference call and therefore also was aware that the Company had secretly written off $1.9 billion from the CDS position, and he further was aware that the liabilities from the long CDS position were deliberately understated to manage earnings and that the valuation of the long CDS position had ignored the observable input represented by the decline in the benchmark ABX index during the same time period.

436. Kelleher directly benefited from misrepresenting Morgan's true financial condition because his compensation was directly tied to the Company's performance. In explaining the compensation awarded to Kelleher in 2007, the 2008 Proxy (filed with the SEC on February 27, 2008) stated that the compensation Committee considered Mr. Kelleher's "accomplishments as Head of Global Capital Markets and his transition into the CFO role, including helping the Company to address issues relating to the disruption in the mortgage securities market during the second half of the year" and awarded Kelleher over ***$11.36 million*** in cash and other incentive compensation for 2007.

XII. LOSS CAUSATION

437. Plaintiffs and Class members were damaged as a result of Defendants' fraudulent conduct as set forth herein. During the Class Period, Defendants knowingly and recklessly engaged in a scheme to deceive the market by issuing a series of materially false and misleading statements (and omitting material facts) relating to, *inter alia*: the magnitude and nature of increased risk in Morgan's proprietary trading; the adequacy of the Company's risk management controls; the Company's ability to produce record results with a purported balanced approach to risk, the limited nature of the Company's exposure to subprime-related losses; the Company's adherence to GAAP (including Morgan's stated practice of reporting assets at fair value); the true purpose behind the Company's reclassification of assets and liabilities from Level 2 to Level 3 in the Third Quarter 2007; the adequacy and nature of the losses and write-downs taken in Third Quarter 2007; the adequacy of the losses and write-downs taken and disclosed on November 7, 2007; the circumstances leading to the Company's sub-prime-related write-downs and related material losses in Third and Fourth Quarter 2007; and the Company's purported ability to outperform its Wall

Street peers in the prevailing economic environment in 2007.

438. As a direct result of the Defendants' scheme, misrepresentations, and omissions of material facts, the price of Morgan's common stock was artificially inflated throughout the Class Period.

439. Class members unwittingly and in reliance upon Defendants' materially false and misleading statements and/or omissions purchased Morgan's common stock at artificially-inflated prices. But for the Defendants' material misrepresentations, omissions and fraudulent acts, Plaintiffs and other Class members would not have purchased Morgan's stock at all, or would not have purchased it at the artificially-inflated prices at which it traded during the Class Period. As Defendants' material misrepresentations and omissions were gradually revealed to investors and shareholders through a series of partial corrective disclosures, Morgan's stock fell precipitously as the artificial inflation caused by the Defendants' conduct was removed from Morgan's stock price.

440. The declines in the Company's stock price between November 1, 2007 and the end of the Class Period, including, but not limited to, the declines summarized below, are directly attributable to the market absorbing information correcting the Defendants' fraudulent misrepresentations and omissions and/or the materialization of risks concealed by Defendants from Morgan's investors and shareholders.

441. Plaintiffs and other members of the Class suffered substantial economic losses as the price of Morgan's stock fell in response to the issuance of partial corrective disclosures and/or the materialization of risks concealed by the Defendants from Morgan's investors and shareholders. The following corrective disclosures caused Morgan's stock to drop, thereby damaging investors, are representative, not exclusive, of the partial corrective disclosures and/or the materialization of concealed risks that led to Plaintiffs' and other putative Class members' damages for which relief is sought in this matter.

A. <u>The Events Leading Up to and The Company's Initial Revelations About Its Subprime Exposure on November 7, 2007</u>

442. Between November 1 and November 7, 2007, first rumors, then speculation, and finally, on November 7, 2007, confirmation by the Company of large losses relating to previously-

undisclosed exposures to U.S. subprime markets caused Morgan's stock price to fall from $67.26, the closing price on October 31, 2007 to $51.19, the closing price on November 7.

443. On Thursday, November 1, 2007, Mike Mayo, an analyst at Deutsche Bank predicted that Morgan could face large losses due to exposures from CDOs. In part, this speculation was fueled by information leaking into the analyst community by the departures of traders from the Proprietary Trading Group, combined with existing turmoil in the subprime market, all of which suggested that Morgan had a serious problem on its hands.

444. On Friday, November 2, 2007, the Defendants fired Howard Hubler. Although there was no public announcement of Hubler's firing, information about his firing fueled additional rumors and speculation in the market about Morgan's exposure to subprime losses.

445. On November 6, 2007, David Trone, an analyst with Fox-Pitt Kelton Cochran Caronia Waller, issued a report downgrading the rating on Morgan's stock based on the "likelihood that it will take significant write-downs on ABS-CDOs and other mortgage exposures." Fox-Pitt Kelton Cochran Caronia Waller predicted Morgan's "forthcoming write-down could be around $4 bil [sic]" but stated that the analysts "wouldn't be surprised to see $6 bil [sic] in total write-downs..." Trone wrote, "We suggest an outright avoidance until either management discloses more specific exposure data and it proves smaller than we thought, or they actually take writedowns big enough to get beyond this." At 12:35 p.m. the same day, Mike Mayo, the analyst that had launched rumors of a Morgan Stanley writedown the previous week, predicted a write down of $3 to $4 billion, but ascribed the writedown to Morgan's holdings of CDOs.

446. As the market absorbed the information revealed to the public between November 1 and November 6, 2007, Morgan Stanley's common stock fell from its closing price of $67.26 on October 31, 2007, to close at $54.51 on November 6, 2007, a decline of 18.96 %.

447. Before the markets opened on November 7, 2007, the *Wall Street Journal* published an article titled, "Storm May Hit Morgan Stanley After Its Calm --- Write-Downs Projected By Two Analysts," and which appeared in print on the morning of November 7, 2007, and reported that two analysts were projecting write-downs from Morgan based on an "educated guess" (the "November 7, 2007 WSJ Article"). According to the November 7, 2007 WSJ Article:

> Of all the blue-chip Wall Street securities firms, Morgan Stanley seemed one of the least likely to get thumped by the subprime- mortgage crisis. The firm is a bit player in underwriting the securities known as collateralized-debt obligations that have rocked Merrill Lynch, Citigroup and others, ranking a distant No. 10. So why are some on Wall Street starting to sweat about Morgan Stanley's exposure to this business? Two analysts are projecting the firm may take a fourth-quarter write-down of $3 billion to $6 billion. The estimates by analysts David Trone of Fox-Pitt, Kelton and Mike Mayo of Deutsche Bank AG contributed to Morgan Stanley stock's falling $1.08, or 1.94%, yesterday in New York Stock Exchange trading to $54.51 a share. Mr. Trone projected the possible write-downs at $4 billion to $6 billion, Mr. Mayo $3 billion to $4 billion. While the firm may not have underwritten as many CDOs, which are securities backed by pools of assets such as mortgages, Morgan Stanley may have been involved in transactions with other firms that left it with exposure to CDO risks, market participants say. Such proprietary trading with the firm's own money already cost the firm $480 million on money-losing quantitative stock trading in the third quarter, with $390 million in losses occurring on a single day in August, according to regulatory filings. Asked by a CNBC reporter Monday about possible fourth-quarter write-downs, Morgan Stanley Chief Executive John Mack indicated he expected numerous firms would report such hits because market prices have declined. But he wouldn't address specifics about Morgan Stanley.

448. On the evening of November 7, 2007, after the close of the markets, Morgan issued a press release disclosing significant declines in subprime-related exposures and a staggering $3.7 billion write down for the two-month period ended October 31, 2007.

449. Since the initial analyst speculation of Morgan's losses, the Company's share price had fallen 23.9% from $67.26 from the close on October 31, 2007 to $51.19 on November 7, 2007, the date of the Company's disclose of its losses, reducing the Company's market capitalization by $17.03 billion.

450. In announcing that Morgan held an additional $6 billion in net subprime exposure on its balance sheet, Kelleher responded whether this additional exposure should be viewed as a potential for an additional $3.9 billion after-tax writedown at the end of the quarter. Kelleher responded:

> I mean, you can think about it in that way. Look, I mean, $6 billion net exposure, what we've done in this disclosure is to give the exposures rather than the balance sheet balances. $6 billion is assuming zero recovery, 100% write-off -- sorry -- 100%defaults, zero recovery. That is an incredibly extreme place to be. Now, I'm not going to predictive about whether that's likely or not. But, ultimately, if you're going to say in extremist, from the-- sort of an exact point of view, what would be the worst case scenario, it would be $6 billion. But you're having to assume 100% default rates and zero recovery.

451. What Kelleher failed to disclose is that the trend in the ABX Index, as of November

7, 2007, pointed to a virtual certainty of further writedowns and that the so-called "worst case" scenario identified on the call was already unfolding. Furthermore, Kelleher failed to disclose that Morgan's had no models or risk controls, as recognized by Defendant Daula after the end of the Class Period, to properly value these positions, and that these problems would continue to imperil Morgan's performance going forward.

B. Firings and Demotions, and Final Disclosure of the Company's True Financial Condition

452. On November 29, 2007, Defendant Mack fired Zoe Cruz and demoted Neal Shear, in connection with their conduct that resulted in Morgan's losses. Anthony Tufariello, global head of securitized products at Morgan Stanley, was also fired. The firing of Cruz and Tufariello, and the demotion of super star trader like Shear further revealed the extent of the risk management problems within Morgan and its reduced prospects for growth going forward. As analysts at Punk, Ziegel and Company reported the following day, "this shake-up continues the management instability at this firm which has lasted for four years now. This is clearly quite negative. The firm will never make headway toward developing consistent earnings growth if the players on the team keep shifting and the strategies being employed are constantly shifting." On December 3, 2007 and December 4, 2007, analysts from Deutsche Bank and Credit Suisse, respectively, further downgraded the Company's prospects for the quarter. Between November 7, 2007 and December 4, 2007, these additional revelations about Morgan's failures, further eroded confidence that the Company's losses would be limited.

453. On December 19, 2007, Morgan disclosed that the total writedown of subprime and other mortgage-related exposures for the Fourth Quarter 2007 as $9.4 billion, of which $7.8 billion was attributed to the long CDS position. Defendant Mack finally admitted what the market had been absorbing since the Company's announcement on November 7, 2007, which is that Morgan's losses were the result, in part, from an aggressive subprime bet, the "failure to manage that risk appropriately" and the concealment of such by the knowing and/or reckless conduct of its senior executives. According, to Mack, "[m]ake no mistake, we've held people accountable."

454. While the Defendants staved off a hammering of the Company's stock price with

contemporaneous news of a $5 billion cash infusion from China's CIC, which investors favorably responded to by pushing the stock up 7% to close at $50.58, the effect of Morgan's true financial condition and earnings prospects being revealed since the initial disclosure on November 7, 2007 was dramatic.

455. Between November 7, 2007 and December 18, 2007, Morgan's stock price had fallen from $51.19 to $48.07, a further 6% decline, representing an additional market capitalization loss of approximately $3.30 billion.

XIII. APPLICABILITY OF PRESUMPTION OF RELIANCE: THE FRAUD ON THE MARKET DOCTRINE

456. The market for Morgan's securities was open and efficient at all relevant times for the following reasons (among others):

- The Company's securities met the requirements for listing, and were listed and actively traded on the NYSE;
- As a regulated issuer, Morgan filed periodic public reports with the SEC;
- Morgan regularly communicated with public investors via established market communication mechanisms, including through regular disseminations of press releases on the national circuits of major newswire services and through other wide-ranging public disclosures, such as communications with the financial press and other similar reporting services;
- The market reacted to public information disseminated by Morgan;
- Morgan was followed by numerous securities analysts employed by major brokerage firms who wrote reports which were distributed to the sales force and certain customers of their respective brokerage firms. Each of these reports was publicly available and entered the public market place;
- The material misrepresentations and omissions alleged herein would tend to induce a reasonable investor to misjudge the value of Morgan's securities; and
- Without knowledge of the misrepresented or omitted material facts, Plaintiffs and the other members of the Class purchased or otherwise acquired Morgan's registered securities between the time Defendants made the material misrepresentations and omissions and the time the fraudulent scheme was being disclosed, during which time the price of Morgan's securities was inflated by Defendants' misrepresentations and omissions.

457. As a result of the foregoing, the market for Morgan's common stock promptly

digested current information regarding Morgan from all publicly available sources and reflected such information in Morgan's securities prices. Under these circumstances, all purchasers and acquirers of Morgan's securities during the Class Period suffered similar injury through their purchase or acquisition of Morgan's securities at artificially inflated prices and a presumption of reliance applies.

XIV. INAPPICABILITY OF SAFE HARBOR

458. As alleged herein, the Defendants acted with scienter because at the time that they issued public documents and other statements in Morgan's name, they knew or with extreme recklessness disregarded the fact that such statements were materially false and misleading or omitted material facts. Moreover, the Defendants knew such documents and statements would be issued or disseminated to the investing public, knew that persons were likely to rely upon those misrepresentations and omissions, and knowingly and recklessly participated in the issuance and dissemination of such statements and documents as primary violators of the federal securities laws.

459. As set forth in detail throughout this Complaint, the Defendants, by virtue of their control over, and/or receipt of Morgan's materially misleading statements and their positions with the Company that made them privy to confidential proprietary information, used such information to artificially inflate Morgan's financial results. The Defendants created, were informed of, participated in and knew of the scheme alleged herein to distort and suppress material information pertaining to Morgan's financial condition, profitability and present and future prospects of the Company. With respect to non-forward looking statements and omissions, the Defendants knew and recklessly disregarded the falsity and misleading nature of that information, which they caused to be disseminated to the investing public.

460. The statutory safe harbor provided for forward-looking statements under certain circumstances does not apply to any of the false statements pleaded in this Complaint. None of the statements pleaded herein are "forward-looking" statements and no such statement was identified as a "forward-looking statement" when made. Rather, the statements alleged herein to be materially false and misleading by affirmative misstatement and/or omissions of material fact all relate to facts and conditions existing at the time the statements were made. Moreover, cautionary

statements, if any, did not identify important factors that could cause actual results to differ materially from those in any putative forward-looking statements.

461. In the alternative, to the extent that the statutory safe harbor does apply to any statement pleaded herein which is deemed to be forward-looking, the Defendants are liable for such false forward-looking statements because at the time each such statement was made, the speaker actually knew and/or with extreme recklessness disregarded the fact that forward-looking statements were materially false or misleading and/or omitted facts necessary to make statements previously made not materially false and misleading, and/or that each such statement was authorized and/or approved by a director and/or executive officer of Morgan who actually knew or with extreme recklessness disregarded the fact that each such statement was false and/or misleading when made. None of the historic or present tense statements made by the Defendants was an assumption underlying or relating to any plan, projection, or statement of future economic performance, as they were not stated to be such an assumption underlying or relating to any projection or statement of future economic performance when made nor were any of the projections or forecasts made by the Defendants expressly related to or stated to be dependent on those historic or present tense statements when made.

XV. CLASS ACTION ALLEGATIONS

462. Plaintiffs bring this action as a class action pursuant to Rule 23(a) and (b)(3) of the Federal Rules of Civil Procedure on behalf of all persons and entities who purchased Morgan common stock during the Class Period (from June 20, 2007 to December 19, 2007, inclusive) and who suffered damages as a result of their purchases (the "Class"). Excluded from the Class are: (1) the Company and the Individual Defendants; (2) members of the immediate family of each of the Individual Defendants; (3) the subsidiaries or affiliates of the Company or any of the Defendants; (4) any person or entity who is, or was during the Class Period, a partner, officer, director, employee or controlling person of the Company or any of the Defendants; (5) any entity in which any of the Defendants has a controlling interest; and (6) the legal representatives, heirs, successors or assigns of any of the excluded persons or entities specified in this paragraph.

463. The members of the Class are so numerous that joinder of all members is

impracticable. As of the date of this Complaint, there were approximately 1.1 billion shares of Morgan's common stock outstanding. While Plaintiffs do not know the exact number of Class members, Plaintiffs believe that there are, at minimum, thousands of members of the Class who purchased Morgan's common stock during the Class Period.

464. A class action is superior to other available methods for the fair and efficient adjudication of this controversy.

465. Common questions of law and fact exist as to all members of the Class, and predominate over any questions affecting solely individual members of the Class. Among the questions of law and fact common to the Class are:

- Whether the federal securities laws were violated by the Defendants' acts as alleged herein;
- Whether the SEC filings and other public statements published and disseminated by the Defendants to the investing public and purchasers of Morgan's securities during the Class Period omitted and/or misrepresented material facts about Morgan's financial condition, profitability, risks of investing in the Company, effectiveness of its controls or present and/or future prospects of the Company;
- Whether the Defendants omitted to state and/or misrepresented material facts about the financial condition, profitability, risks of investing in the Company, effectiveness of its controls or present and/or future prospects of the Company;
- Whether the Defendants acted willfully or with extreme recklessness in omitting to state and/or misrepresenting material facts about the financial condition, profitability, risks of investing in the Company, effectiveness of its controls or present and/or future prospects of the Company;
- Whether the market price of Morgan's common stock during the Class Period was artificially inflated due to the material non-disclosures and/or misrepresentations complained of herein; and
- Whether the members of the Class have sustained damages, and, if so, what is the proper measure thereof.

466. Plaintiffs' claims are typical of the claims of the members of the Class. Lead Plaintiff will fairly and adequately protect the interests of the members of the Class and have retained counsel competent and experienced in class and securities litigation. Lead Plaintiff has no interests that are adverse or antagonistic to the Class.

467. A class action is superior to other available methods for fair and efficient adjudication of the controversy since joinder of all members of the Class is impracticable. Furthermore, because damages suffered by the individual Class members may be relatively small, the expense and burden of individual litigation make it impossible for the Class members individually to redress the Defendants' wrongful conduct. Furthermore, there will be no difficulty in the management of this litigation as a class action.

XVI. COUNTS

COUNT I

For Violation of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder (Against All Defendants except Lynch, referred to as "Rule 10b-5 Defendants")

468. Plaintiffs repeat and reallege each and every allegations in the foregoing paragraphs of this Complaint as if fully set forth herein. This claim is asserted against all Rule 10b-5 Defendants.

469. During the Class Period, the Rule 10b-5 Defendants: (a) knowingly and recklessly deceived the investing public, including Plaintiffs, as alleged herein; (b) artificially inflated the market price of Morgan's common stock; and (c) caused Plaintiffs and the Class to purchase or otherwise acquire Morgan Stanley common stock at artificially-inflated prices.

470. Each of the Rule 10b-5 Defendants, in violation of Section 10(b) of the Exchange Act and Rule 10b-5(b), made untrue statements of material facts and/or omitted to state material facts necessary to make the statements made by the Rule 10b-5 Defendants not misleading, and/or substantially participated in the creation of the alleged misrepresentation, which operated as a fraud and deceit upon Plaintiffs and the Class, in an effort to maintain the artificially-inflated price of Morgan Stanley's common stock during the Class Period. The Rule 10b-5 Defendants' false and misleading statements (and omissions of material facts) are set forth in Sections VIII and IX, *supra*.

471. As a result of their making and/or substantially participating in the creation of affirmative statements to the investing public, the Rule 10b-5 Defendants had a duty to promptly disseminate truthful information that would be material to investors in compliance with applicable laws and regulations.

472. The Rule 10b-5 Defendants, individually and in concert, directly and indirectly, by the use, means or instrumentalities of interstate commerce and/or of the mails, made or substantially participated in the creation/dissemination of, untrue statements of material fact as set forth herein, or with extreme recklessness failed to ascertain and disclose truthful facts, even though such facts were available to them.

473. The facts alleged herein give rise to a strong inference that each of the Rule 10b-5 Defendants acted with scienter. Each of the Defendants knew or with extreme recklessness disregarded that the Class Period statements set forth in Sections VIII and IX, *supra*, were materially false and misleading for the reasons set forth herein.

474. The Rule 10b-5 Defendants carried out a deliberate scheme to misrepresent the value of Morgan Stanley's assets, the risks the Company's investors were being exposed to and the effectiveness of Morgan Stanley's controls.

475. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, the market price of Morgan's securities was artificially inflated throughout the Class Period. Unaware that the market price of Morgan's common stock was artificially inflated, and relying directly or indirectly on the false and misleading statements made by the Rule 10b-5 Defendants, or upon the integrity of the markets in which Morgan's common stock traded, and the truth of any representations made to appropriate agencies and to the investing public, at the times at which any statements were made, and/or in the absence of material adverse information that was known, or with deliberate recklessness disregarded, by the Defendants but not disclosed in their public statements, Plaintiffs purchased or acquired Morgan's common stock at artificially-inflated prices. As a direct and proximate result of Rule 10b-5 Defendants' wrongful conduct, Plaintiffs and the other members of the Class suffered damages in connection with their respective purchases and sales of Morgan's common stock during the Class Period, when the inflation in the price of Morgan's common stock was gradually removed as the truth regarding Rule 10b-5 Defendants' conduct was revealed causing the price of Morgan's common stock to decline and thereby resulting in economic losses to Plaintiffs and the Class.

476. By reason of the foregoing, the Rule 10b-5 Defendants violated Section 10(b) of the

Exchange Act and Rule 10b-5(b) promulgated thereunder, and are liable to Plaintiffs and the Class for damages suffered in connection with their transactions in Morgan's common stock during the Class Period.

COUNT II

For Violation of Section 20(a) of the Exchange Act (Against the Individual Defendants)

477. Plaintiffs repeat and reallege each and every allegations in the foregoing paragraphs of this Complaint as if fully set forth herein. This claim is asserted against the Individual Defendants.

478. Morgan Stanley is primary violator of Section 10(b) and Rule 10b-5, promulgated thereunder.

479. The Individual Defendants acted as controlling persons of Morgan within the meaning of Section 20(a) of the Exchange Act, as alleged herein. By reason of their positions as officers and/or directors of Morgan, their ability to approve the issuance of statements, their ownership of Morgan's securities and/or by contract. As such, the Individual Defendants had the power and authority to direct and control, and did direct and control, directly or indirectly, the decision-making of the Company as set forth herein. The Individual Defendants were provided with or had unrestricted access to copies of the Company's reports, press releases, public filings and other statements alleged by Plaintiffs to be misleading prior to and/or shortly after these statements were issued and had the ability to prevent the issuance of the statements or cause the statements to be corrected. Each of the Individual Defendants had direct and supervisory involvement in the day-to-day operations of the Company and, therefore, is presumed to have had the power to control or influence, and during the Class Period did exercise their power to control and influence, the conduct giving rise to the violations of the federal securities laws alleged herein. The Individual Defendants prepared, or were responsible for preparing, the Company's press releases and SEC filings and made statements to the market in SEC filings, annual reports, press releases, news articles and conference calls. The Individual Defendants controlled Morgan Stanley and each of its employees.

480. By virtue of their positions as controlling persons of Morgan, and by reason of the conduct described in this Count, the Individual Defendants are liable pursuant to Section 20(a) of the Exchange Act for controlling primary a violator of the federal securities laws.

481. As a direct and proximate result of the Individual Defendants' wrongful conduct, Plaintiffs and other members of the Class suffered damages in connection with their purchases of the Company's common stock during the Class Period.

XVII. PRAYER FOR RELIEF

WHEREFORE, Plaintiffs pray for relief and judgment, including preliminary and permanent injunctive relief, as follows:

A. Determining that this action is a proper class action, and certifying Plaintiffs as class representatives under Rule 23 of the Federal Rules of Civil Procedure;

B. Awarding preliminary and permanent injunctive relief in favor of Plaintiffs and the Class against all defendants and their counsel, agents and all persons acting under, in concert with or for them;

C. Restitution of investors' monies of which they were defrauded;

F. Awarding compensatory damages in favor of Plaintiffs and the other Class members against all defendants, jointly and severally, for all damages sustained as a result of Defendants' conduct set forth herein, in an amount to be proven at trial, including interest thereon;

G. Awarding Plaintiffs and the Class their reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and

H. Such other and further relief as the Court may deem just and proper.

XVIII. JURY DEMAND

Plaintiffs demand a trial by jury.

Dated: November 24, 2008

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State-Boston Retirement System

SCHEDULE “A”

CERTIFICATION OF AGNETA WILHELMSON KÅREMAR IN SUPPORT OF FJÄRDE AP-FONDEN'S MOTION FOR CONSOLIDATION, FOR ITS APPOINTMENT AS LEAD PLAINTIFF, AND FOR THE APPROVAL OF ITS SELECTION OF COUNSEL

Fjärde AP-Fonden ("AP4" or "Plaintiff"), declares, as to the claims asserted under the federal securities laws, that:

1. I, Agneta Wilhelmson Kåremar, am Administrative Director of AP4. I have reviewed the Amended Complaint and authorized its filing by Barroway Topaz Kessler Meltzer & Check, LLP.

2. AP4 did not purchase the security that is the subject of this action at the direction of Plaintiff's counsel or in order to participate in any private action.

3. AP4 is willing to serve as a representative party on behalf of the class, including providing testimony at deposition and trial, if necessary.

4. Attached in Schedule A are AP4's transactions in Morgan Stanley (NYSE: MS) securities during the Class Period.

5. AP4 has, within the three year period preceding the date hereof, sought to serve as a representative party in federal securities class actions against Citigroup, Inc and Wachovia Corporation.

6. AP4 will not accept any payment for serving as a representative party on behalf of the class beyond Plaintiff's pro rata share of any recovery, except such reasonable costs and expenses directly relating to the representation of the class as ordered or approved by the Court.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed this 20 day of November, 2008.

Fjärde AP-Fonden

By: ______________________
Agneta Wilhelmson Kåremar
Administrative Director

SCHEDULE A

Date	Purchase or Sale	Type of Securities	Number of Securities	Price of Securities
8/8/2007	Purchase	Com Stk	46,000	65.9497
12/17/2007	Purchase	Com Stk	72,063	49.6498