

***The Role of the Board in the Risk
Management Failure at Morgan Stanley***

CtW Investment Group
March 28, 2008

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The Failure at Morgan Stanley

Summary of CtW Position

- Beginning in fall 2005, Morgan Stanley aggressively increased its risk profile beyond its capacity to manage that risk.
- The Board and Audit Committee failed to moderate a willful CEO's aggressive risk appetite and ensure adequate risk management. Of specific concern, the Committee allowed the CEO to compromise the independence of the firm's risk management in October 2005.
- These Board and Committee failures led to \$10.6 billion in subprime-related writedowns to date. We interpret management's recent statements as acknowledgment that the October 2005 change in risk management contributed to these losses.
- The Board is taking steps to strengthen risk management, but has yet to address the underlying failures that enabled Mr. Mack's penchant for risk taking to go unchecked.

Morgan Stanley's View: \$9.4B Subprime Writedowns Mostly Due to Single Desk

- \$7.8B in single desk losses equals 43% of 2006 average common equity for allocated to the Institutional Securities group
- Size of trading loss prompted Moody's to raise questions regarding the "effectiveness of Morgan Stanley's trading risk management."
- "It just behooves me to think that you guys could have one desk that could lose \$8 billion." (Goldman Sachs Analyst William Tanoma during Morgan Stanley's 12/19/07 Investor Call)

"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." (CEO John Mack, 12/19/07 Investor Call.)

Mack Named MS Chairman & CEO, June '05

Decisive CEO Outlines Plan to Increase Risk

- "I think there is huge opportunities within the institutional business still that we just haven't used. And we need to create an environment where you do take reasonable risk. ... You don't shoot the person that makes the mistake. That's how we learn, as long as they don't make the same mistake twice. And we have got to encourage a sense of entrepreneurship under some rubric of risk control, which I think we are going to do."
(Chairman & CEO John Mack, August 17, 2005)
- According to Mr Mack, the previous regime had become a bureaucracy-bound "culture of 'no'". "It took you months to get an answer and usually it was no," says one executive. In contrast, Mr Mack makes quick decisions and gives his subordinates much greater autonomy. ...He has also tried to encourage more risk-taking. *(Financial Times, June 28, 2006)*

Sources: Morgan Stanley Quarterly Earnings Conference Call – Final, FD (Fair Disclosure) Wire, August 17, 2005.;
"On hold? Swifter decisions but no 'quick fix' at the bank to which Mack went back," *Financial Times*, June 28, 2006.

New Business Plan Disclosed Fall 2005

Detailed at Merrill Lynch Banking Conference on Nov. 15

Institutional Securities: Critical Initiatives

Priorities

- Identify and pursue highest growth opportunities
- Balance agency model with principal risk
- Improve cross divisional and global cooperation
- Invest in product innovation and technology



Critical Initiatives

- Principal risk taking
- Derivatives products
- Domestic and global residential mortgage
- Leveraged finance
- Emerging markets
- Financing / prime brokerage
- Core equities

“The growth initiatives we've described today will require us to increase risk and balance sheet usage. This increase will happen over time and we are very mindful of maintaining our culture of risk management.”

CEO John Mack, 11/15/05

Morgan Stanley

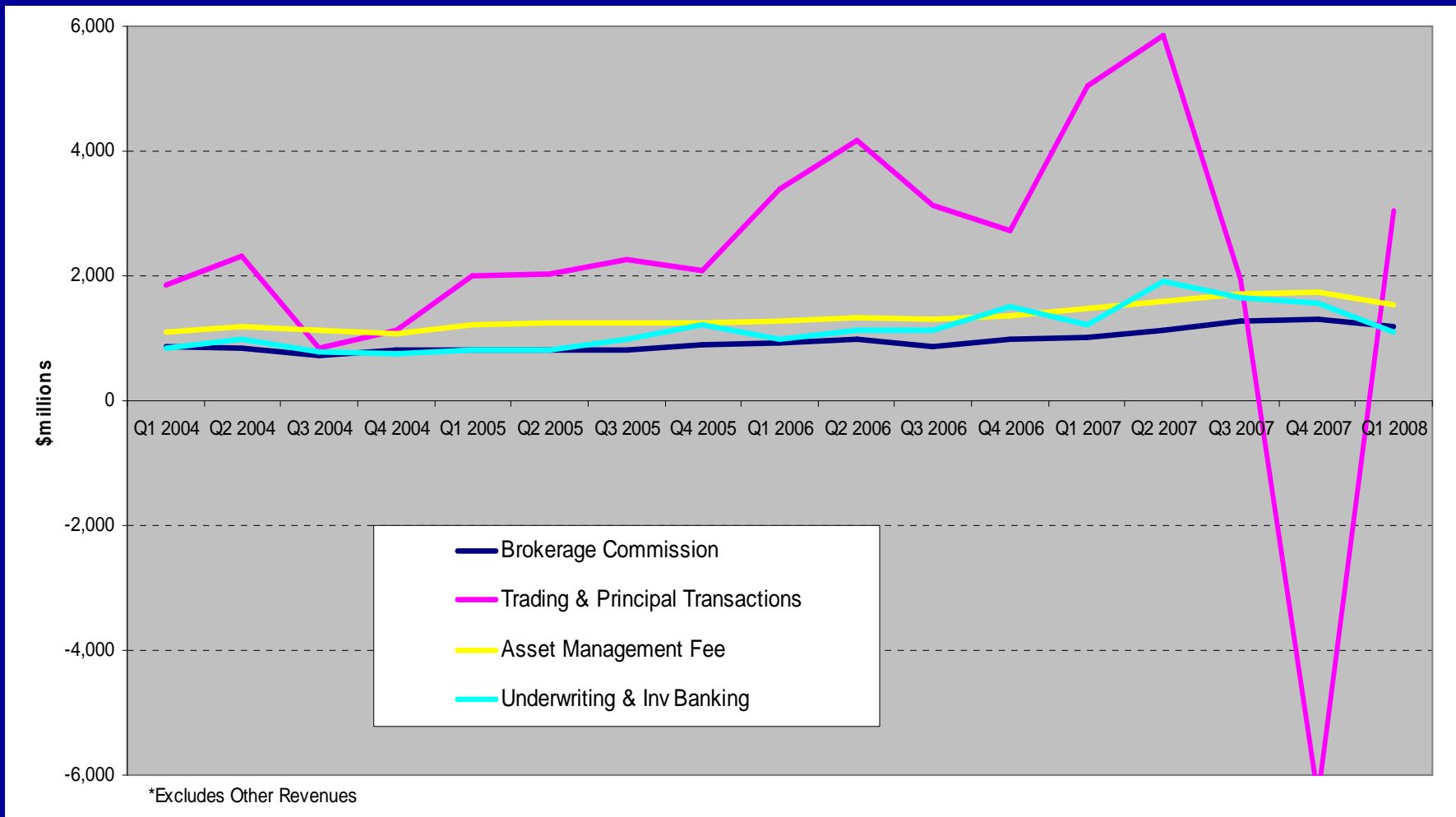
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Sources: John J. Mack and David H. Sidwell Powerpoint to Merrill Lynch 2005 Banking & Financial Services Investor Conference, available at http://www.morganstanley.com/about/ir/presentations/merrill_lynch11152005.pdf; and Transcript from “Morgan Stanley at Merrill Lynch Banking & Financial Services Investor Conference”— FD (Fair Disclosure) Wire, November 15, 2005.

Quarterly Revenue by Source*, Q1'04 – Q1 '08

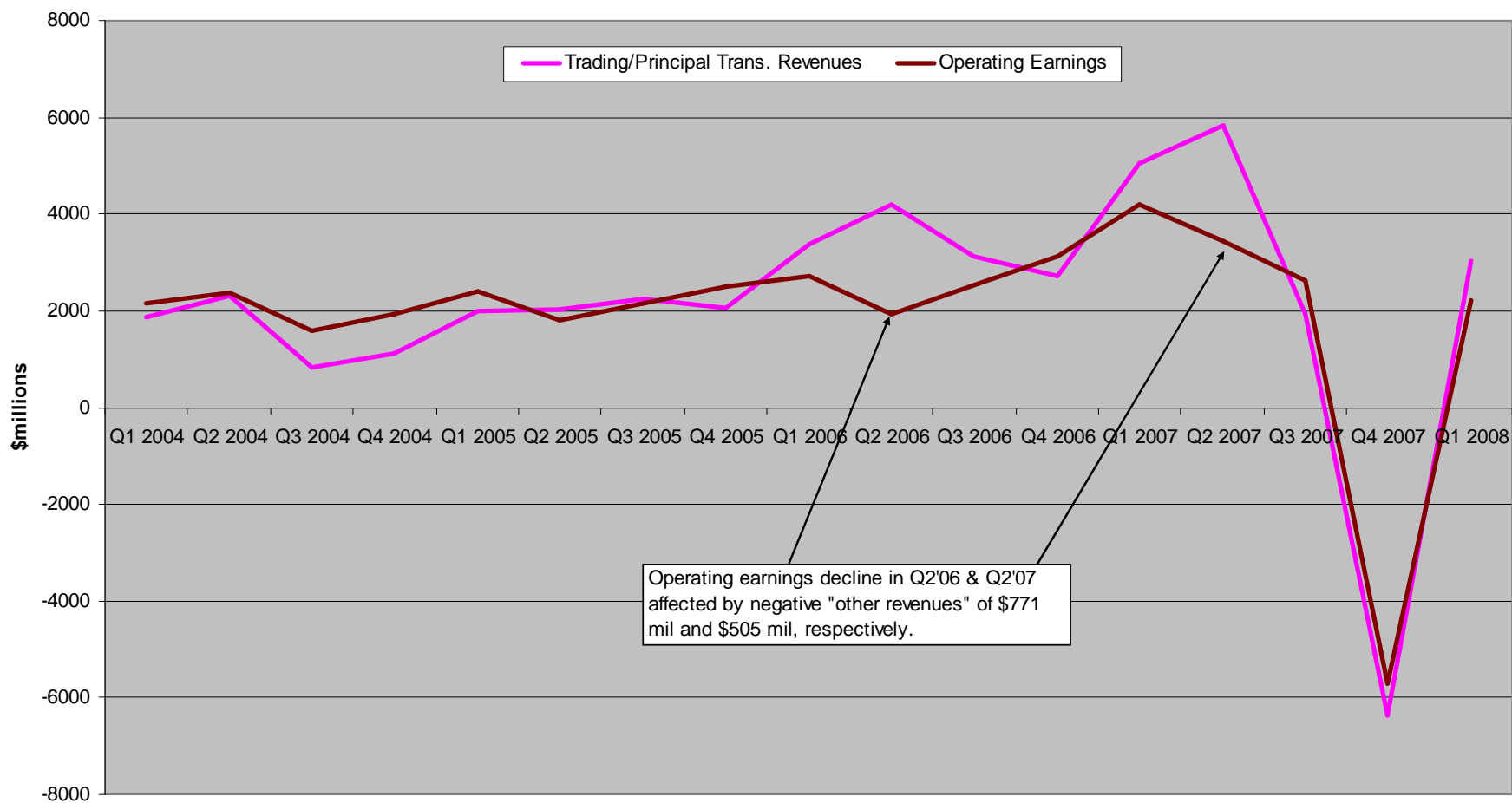
Volatile Trading Revenues Surge 182%, Q4'05 to Q2'07



Source: Capital IQ, based on Morgan Stanley disclosures. *Excludes "Other Revenues"

Trading Revenues Drive Op. Profit Trends

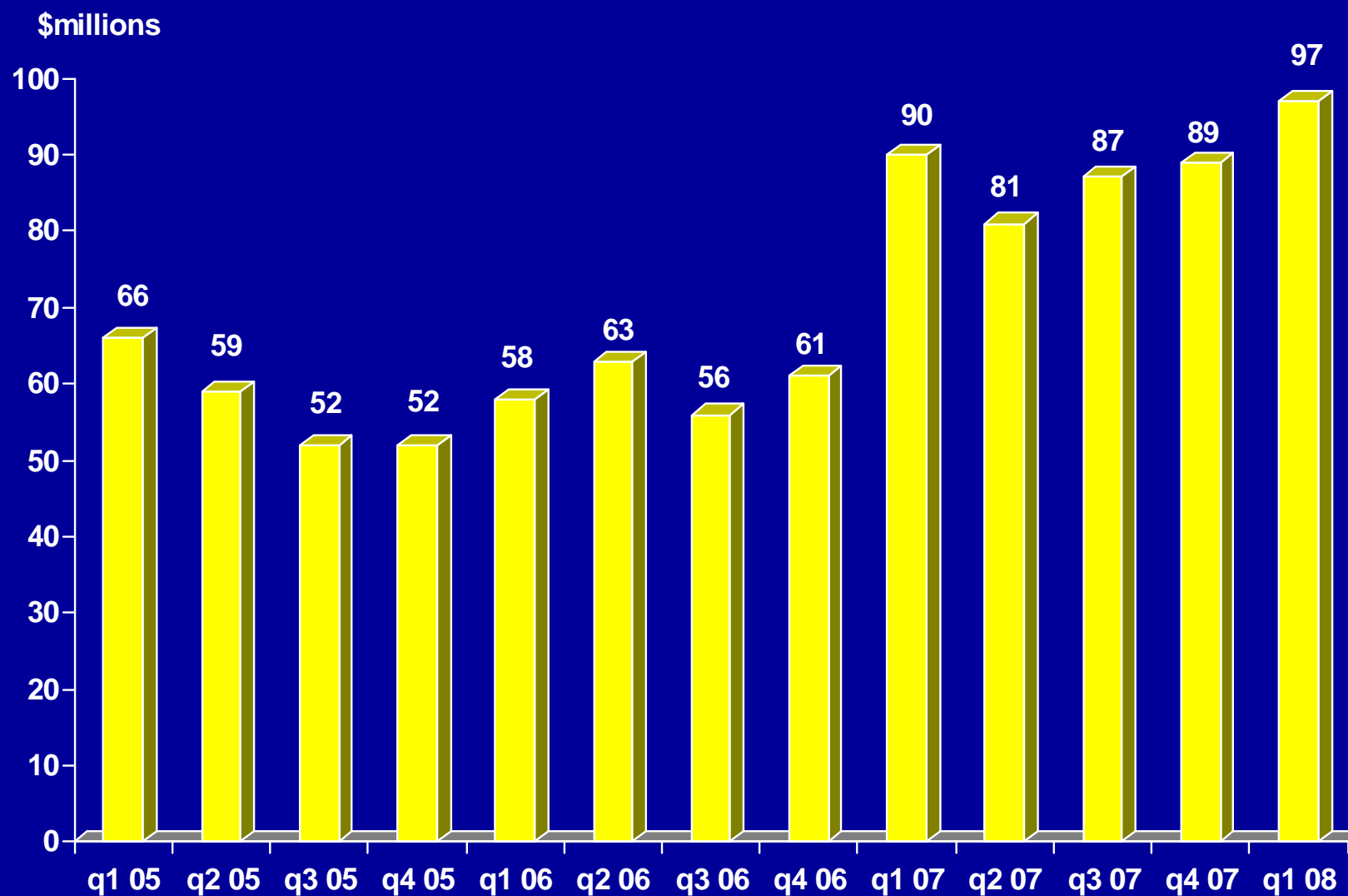
Quarterly Trading Revenues vs. Operating Earnings, Q1 2004 - Q1 2008



Source: Capital IQ, based on Morgan Stanley disclosures.

Trading VaR by Quarter, 2005- Q1 2008

Average Daily Exposure Surges in 2007; Unabated in Q1 2008



Source: Morgan Stanley 2006 and 2007 10K's

Risk Up in Q1 '08 Despite CEO Assurances

John Mack assured investors last December that the firm had dialed down its risk appetite, saying,

“I think that we have been sprinting and I think we're going to be kind of jogging right now for a while.”

Notwithstanding such assurances, Morgan Stanley took more risk in first quarter 2008 – as measured by average daily value at risk (VaR) – than any other quarter in its history.

Source: Morgan Stanley 4th Quarter Earnings Conference Call – Final, FD (Fair Disclosure) Wire, December 19, 2007; company documents.

Key Finding of Global Financial Regulators

Subprime Impact Tied to Risk Management Practices

SENIOR SUPERVISORS GROUP

Observations on Risk Management Practices during the Recent Market Turbulence

March 6, 2008



“...firms that experienced material unexpected losses in relevant business lines typically appeared to have been under pressure over the short term either to expand the business aggressively, to a point beyond the capacity of the relevant control infrastructure...”

...In addition, it was critical for firms to have risk management functions that are not only independent, but also have sufficient authority within the organization.” (p. 7)

MS CRO Reported to CEO as of April 2005 **Changed to Co-President in Charge of ISG in Oct. 2005**

“Friday [Morgan Stanley CEO Philip Purcell] promoted Thomas Daula to chief risk officer for the firm, with the new CRO reporting to him. Daula had been head of market risk reporting to Steve Crawford, who was promoted last week to co-president of the firm alongside fixed income chief Zoe Cruz.” (Forbes.com, 4/8/05)

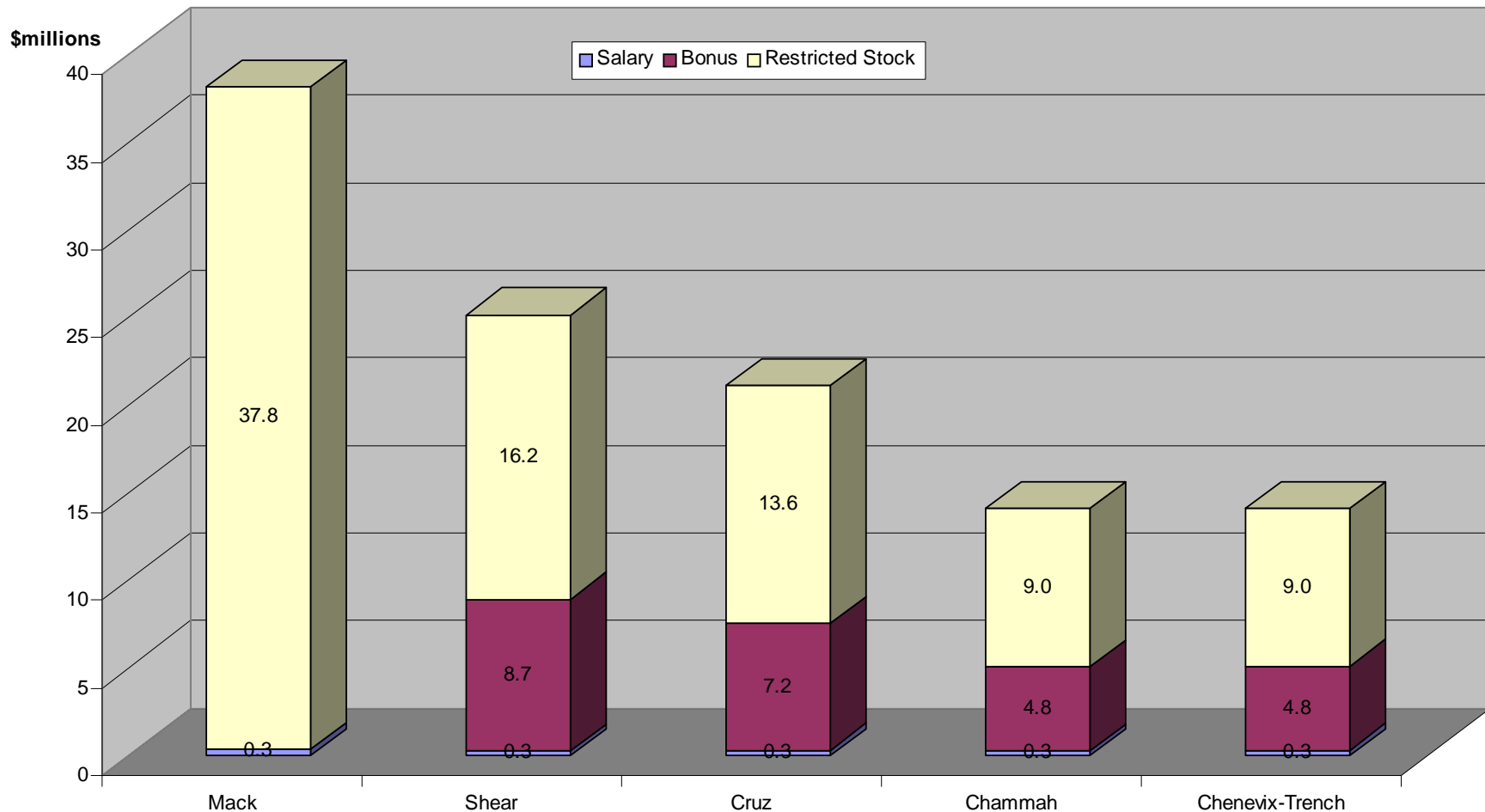
The Oct. 2005 reporting change was neither formally approved by the Board or Audit Committee, nor disclosed to shareholders.

Source: “Purcell: Morgan Stanley CEO Names Daula Risk Chief As Opposition Rages,” Forbes.com, 4/8/05, available at <http://www.forbes.com/2005/04/08/0408autofacescan12.html>

Zoe Cruz's Pay: Annual Bonus is 34% in '05

Incentive Pay for CEO Mack is 100% RSU's

Top 5 Executive Compensation, 2005

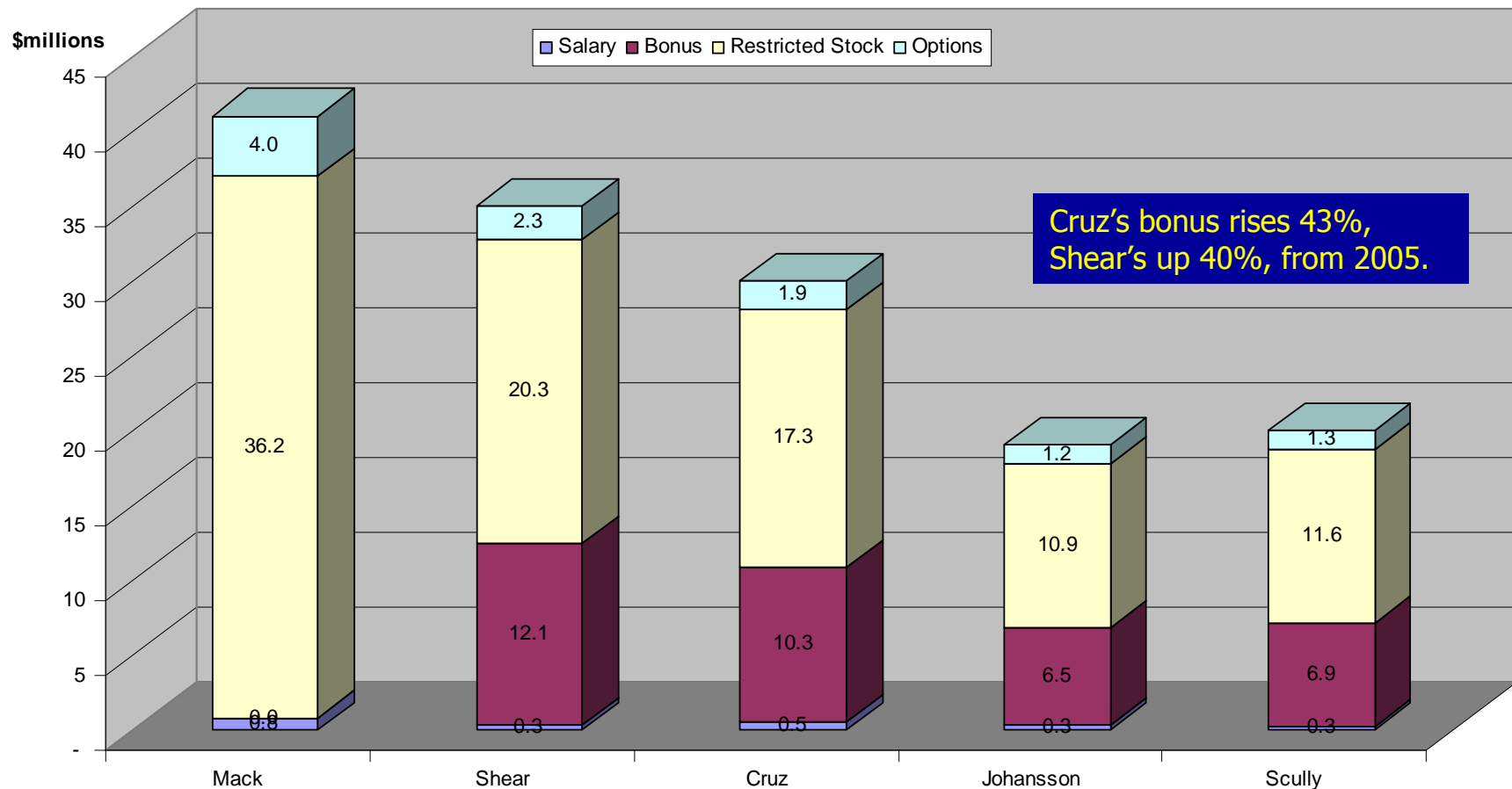


Source: Morgan Stanley 2006 Proxy Statement Note: RSU = Restricted Stock Units

Similar Incentive Pay Breakdown in 2006

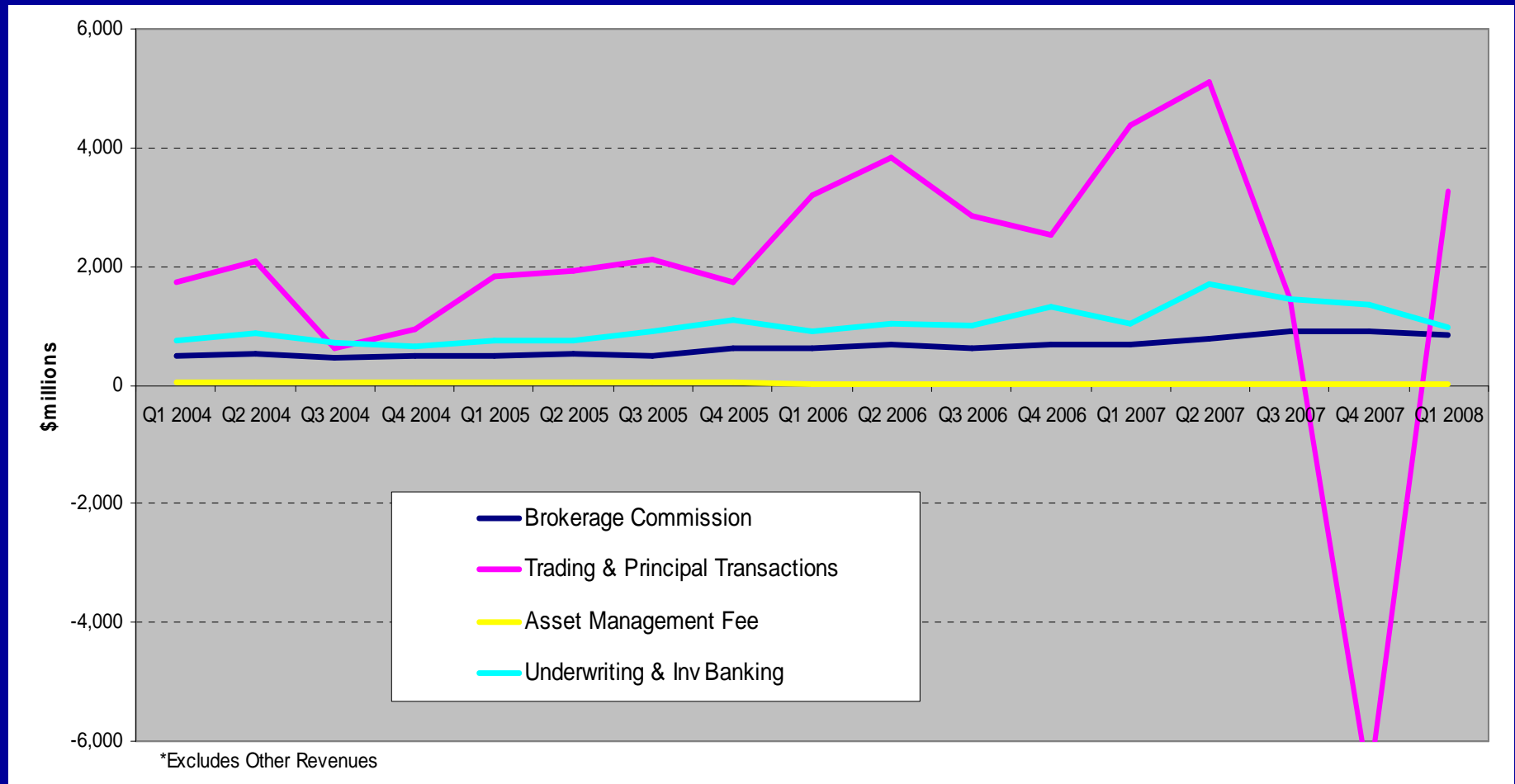
Cash Bonus is 34% of Cruz's Total; 0% for CEO Mack

Top 5 Executive Compensation, 2006



Institutional Securities Segment

Quarterly Revenue by Source*, 2004 – Q1 2008

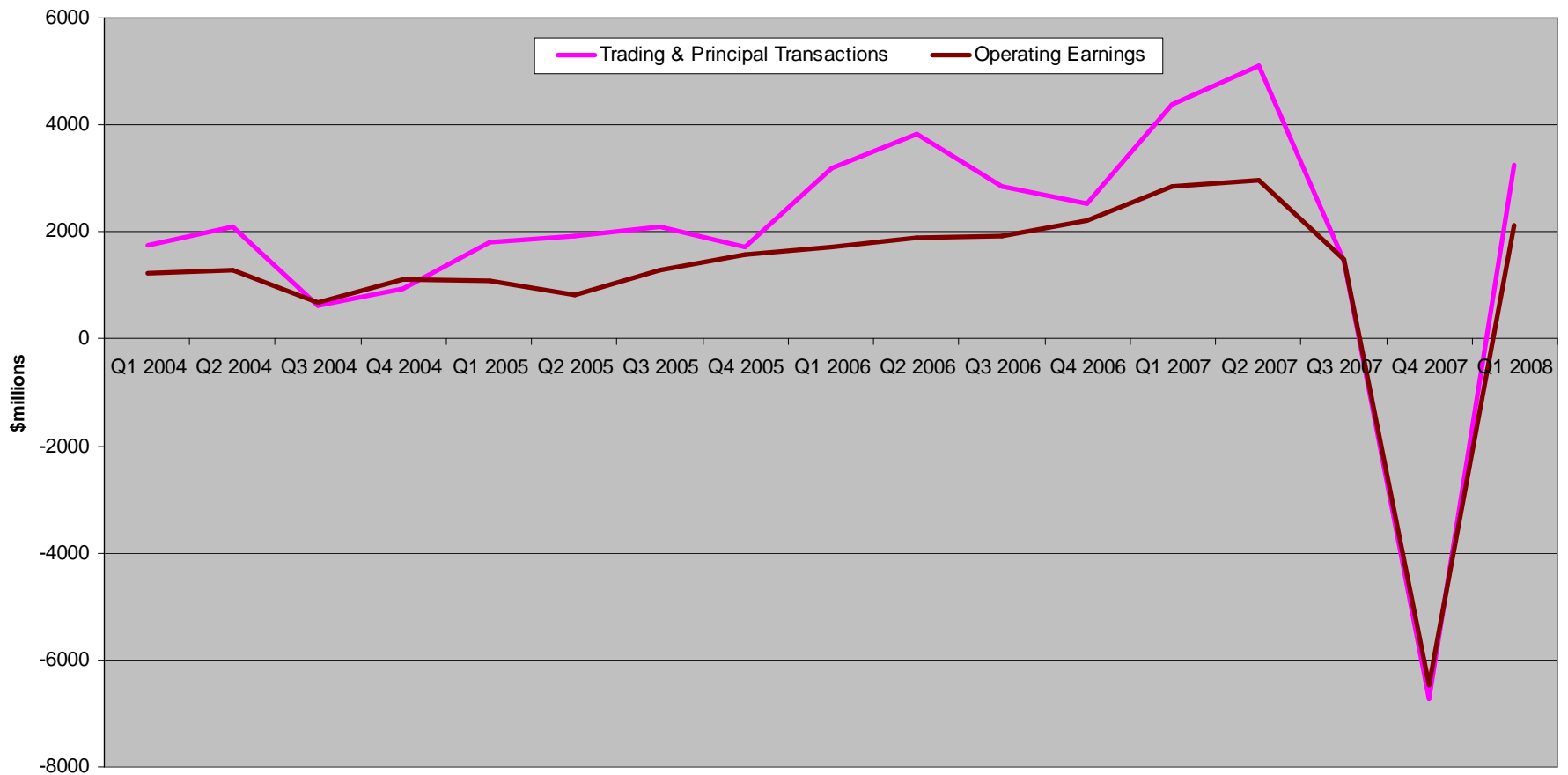


Source: Capital IQ, based on Morgan Stanley disclosures. *Excludes "Other Revenues"

Institutional Securities Segment

Trading Revenues Drive Op. Profit Trends

Quarterly Trading Revenues vs. Operating Earnings, 2004 - Q1 2008



CRO Reporting Structure Not Independent **Acknowledged by Mack on 12/19/07 Investor Call**

ROGER FREEMAN: ...Can you help us think about the changes that you alluded to in risk management? ... And can you just talk about what's actually changed specifically to how things were running and sort of what lead to the issues?

JOHN MACK: Well in the past, the way it was run that risk monitoring and risk management reported in to the President of ISG, so I'm just observing what's going on. 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 and that's why we made the change.

Clarifying the new reporting line in response to Mr. Freeman's follow-up question, Mr. Mack emphasized that **"the key is that risk management now reports to someone outside of the division** and reports to my CFO."

Source: Morgan Stanley 4th Quarter Earnings Conference Call – Final, FD (Fair Disclosure) Wire, December 19, 2007.

Financial Times, 12/22/07

Reports that Cruz Failed to Heed CRO Warnings; CEO Unaware

“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.

...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.”

Source: “Morgan Stanley to review risk role after subprime writedown”, *Financial Times*, 12/22/07

Board Credits CEO for New CRO Reporting Line Calls it an “Aggressive Action” to Enhance Risk Management

“Aggressive actions taken to address significant losses in mortgage securities market and build on momentum in other businesses: Mr. Mack held individuals accountable for the Company’s fourth quarter results and took aggressive action to address the challenges created by changing market conditions, 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;
- Reassessing the Company’s risk culture and risk appetite and **enhancing the Company’s risk management function by strengthening staffing and having it report directly to the CFO**, and creating a new, additional risk monitoring function within the trading business; and
- Consolidating all of the Company’s proprietary trading activities under common leadership.”

Source: CEO Performance discussion on p. 15 of 2008 Proxy Statement

Vote No on Directors Davies, Kidder & Mack CtW to Morgan Stanley Shareholders

We urge you to vote "Against" director nominees Howard J. Davies, C. Robert Kidder and John J. Mack at Morgan Stanley's Annual Meeting of Shareholders on April 8, 2008.

As members of the Board's Audit Committee in fall 2005, we believe that directors Davies and Kidder failed to maintain the integrity of Morgan Stanley's risk management, and thus bear central responsibility for the firm's \$9.4 billion in subprime-related writedowns in 2007.

We believe the circumstances surrounding these risk management failures demonstrate the need for stronger independent leadership at Morgan Stanley. Consistent with best governance practice, we believe John Mack should not serve simultaneously as Chairman and CEO, and are urging shareholders to vote "Against" Mr. Mack to convey that message to the Board.

**Appendices:
Risk Management Best Practice**

Hallmarks of Best-Practice ERM

1. **Engaged senior management and board of directors that set "the tone from the top" and provide organizational support and resources.**
2. **Independent ERM function under the leadership of a chief risk officer (CRO), who reports directly to the CEO with a dotted line to the board.**
3. Top-down governance structure with risk committees at the management and board levels, reinforced by internal and external audit.
4. Established ERM framework that incorporates all of the company's key risks: strategic risk, business risk, operational risk, market risk and credit risk.
5. A risk-aware culture fostered by a common language, training and education, as well as risk-adjusted measures of success and incentives.
6. Written policies with specific risk limits and business boundaries, which collectively represents the risk appetite of the company.
7. An ERM dashboard technology and reporting capability that integrates key quantitative risk metrics and qualitative risk assessments.
8. Robust risk analytics to measure risk concentrations and interdependencies, such as scenario and simulation models.
9. Integration of ERM in strategic planning, business processes & performance measurement.
10. Optimization of the company's risk-adjusted profitability via risk-based product pricing, capital management and risk-transfer strategies.

CRO Reporting Matters

Direct to CEO is Best Practice – Status & Independence

- **“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,** says Ms Mongiardino [VP, senior credit officer & risk management specialist at Moody's Investors Service in London]. (“Risk Management: Four Pillars Of Support”, *The Banker*, 9/1/07)
- **In order to be effective, the CRO must have the full and continuing support of the board and the CEO, with a direct reporting line to the very top.** (“Enterprise Risk Management in Financial Services: From Vision to Value,” *Bank Accounting & Finance*, 12/04)
- **To whom the CRO reports is also an important question. CROs reporting directly to the CEO and the board are often most effective.** To the extent that the CRO reports to the CFO or the Treasurer, and is therefore two or three levels below the CEO, the function becomes increasingly less productive. (“The CRO is Here to Stay”, James Lam, *Risk Management*, 1/1/01).