

# CtW Investment Group

January 23, 2008

Charles H. Noski  
Chair, Audit Committee  
Board of Directors  
Morgan Stanley  
1585 Broadway, Suite D  
New York, New York 10036

Dear Mr. Noski:

Morgan Stanley's failure to manage mortgage-related risk cost its shareholders \$29 billion in 2007, a 34% decline that wiped out all of the shareholder value created since August 2006. As a large and diversified financial services firm that prides itself on managing financial risk, Morgan Stanley's acute vulnerability to the mortgage meltdown has been an especially unwelcome surprise for shareholders.

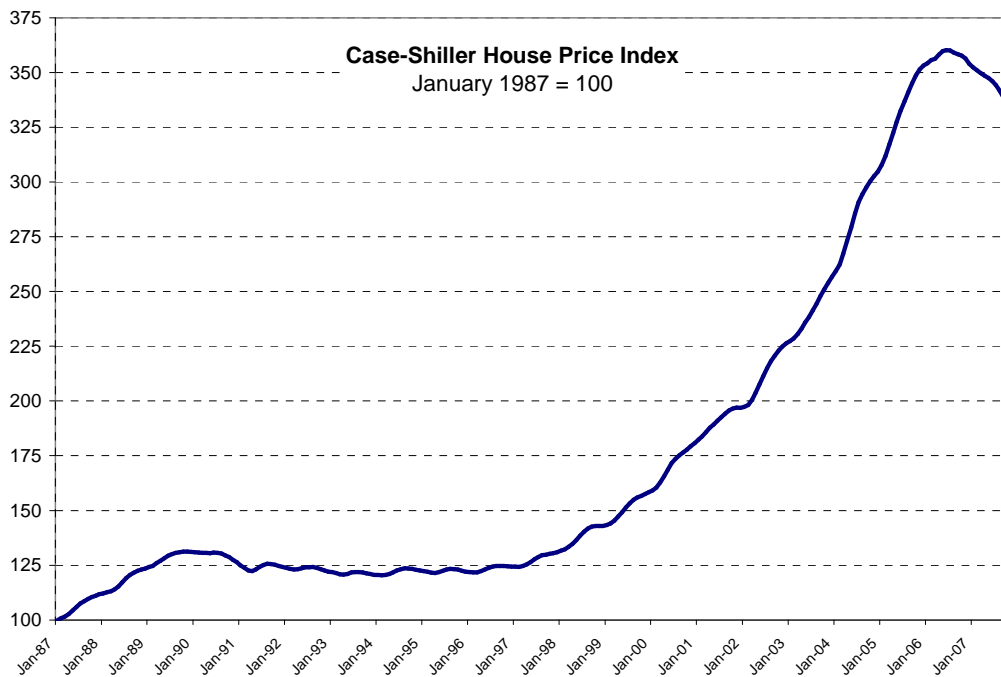
With Morgan Stanley's 2008 director election only three months away, we call on you, as a member of the Audit Committee of the Board of Directors since September 2005, to describe the actions you took in 2005 and 2006 to understand and assess Morgan Stanley's underlying exposure to mortgage risk across its businesses and satisfy yourself that management was taking appropriate steps to control such exposure. Absent a compelling explanation, we intend to recommend that shareholders vote against your re-election at Morgan Stanley's upcoming 2008 annual meeting. The crux of our concern is as follows:

1. By mid-2005 it was apparent that mortgage lenders were loosening lending standards and that an overheated U.S housing market was at risk of collapse. Despite numerous red flags, it appears to us that management failed to control Morgan Stanley's substantial mortgage risk, especially relating to its investments in collateralized debt obligations (CDOs), until it was too late to avoid huge losses. In fact Morgan Stanley substantially increased its mortgage-related exposure in 2006.
2. Audit Committee members should have recognized that the risks of such a collapse had risen dramatically by late 2005 and thus taken particular care to satisfy yourselves that management was taking steps to monitor and control Morgan Stanley's exposure. As Mark Adelson, Head of Structured Finance Research at Nomura Securities, warned in September 2005: "Even the possibility of a [housing] bubble burst should lead [investors] to a defensive position." (*Asset Securitization Report*, September 20, 2005)
3. The unceremonious departure of co-president Zoe Cruz on November 29, 2007 – just three weeks after Morgan Stanley revealed \$3.7 billion in write-downs, mostly related to senior CDOs – does not absolve members of the Audit Committee from responsibility over the prior three years to review the company's financial risk exposure and satisfy yourselves that its exposure to mortgage-related risk was defensible and its risk management systems robust.

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a coalition of unions representing nearly 6 million members, to enhance long-term shareholder value through active ownership. These funds, together with public pension funds in which CtW union members participate, have about \$1.4 trillion in assets and are substantial long-term Morgan Stanley shareholders. We detail our concerns further below.

### The Warning Signs Were There

By mid-2005, it was apparent that a housing bubble had developed and that the risks of a severe mortgage downturn had increased dramatically. Fueled by historically low interest rates, the creation of mortgage products targeting less credit-worthy borrowers and abundant liquidity from a booming secondary market for securitized mortgages, home prices had virtually doubled over the previous five years (see below graph).



Housing starts, which had increased every year since 2000, peaked in second quarter 2005. Mortgage interest rates began rising, with the average rate on a conventional 30-year fixed rate loan jumping from 5.6% to 6.7% between June 2005 and June 2006. Mortgage lenders were loosening their lending standards and increasingly using novel loan products.

One need not have been an economist or the director of financial services firm with access to these data, however, to know that a national housing bubble had developed and could burst. One need only have read the news to see that a growing number of economists, investment professionals and public policy experts were sounding the alarm:

- On May 27, 2005, economist Paul Krugman of the *New York Times* said he saw “signs that America’s housing market, like the stock market at the end of the last decade, is approaching the final, feverish stages of a speculative bubble.”

- On June 9, 2005, Federal Reserve Chairman Alan Greenspan, while downplaying risk of a national housing bubble, acknowledged in testimony to the Joint Economic Committee that he saw “signs of froth in some local markets where home prices seem to have risen to unsustainable levels.”
- On July 26 2005, *The Wall Street Journal* reported that “Mortgage lenders are continuing to loosen their standards, despite growing fears that relaxed lending practices could increase risks for borrowers and lenders in overheated housing markets.” The article cited increases in novel loan products, including interest-only mortgages, option adjustable-rate mortgages and no documentation loans.
- By December 2005, even some CDO traders warned the bubble could burst. Jason Schechter, then head of CDO trading at Lehman Brothers, echoed other participants at the Opal Financial Group CDO Summit when he said: “What concerns me though is: is this liquidity here to stay, or are we at risk for a sizable downturn?” (*Asset Securitization Report*, December 12, 2005)

While Morgan Stanley and many of its peers failed to heed these warnings, a number of firms did take action to reduce their mortgage risk exposure. Goldman Sachs, for example, began aggressively reducing its mortgage-backed securities exposure in late 2006, both by reducing inventory and hedging. Morningstar recently named PIMCO’s Bill Gross the best fixed-income fund manager in 2007, lauding him for avoiding exposure to subprime securities and for anticipating the effect that the decline in home prices would have on the broader economy and corporate bonds.

### **Despite these Red Flags, Morgan Stanley Failed to Control Its Mortgage-Related Risk**

As a leading CDO underwriter and investor, Morgan Stanley has substantial exposure to mortgage-related risk. Despite this concentrated exposure, it appears that management failed to take adequate steps to manage this risk in response to the warning signs of late 2005. In fact, it appears that the company significantly increased its exposure in 2006, including both its direct exposure to subprime mortgages and its indirect exposure through investments in CDOs.

Specifically, in August 2006 Morgan Stanley acquired Saxon Capital, a “premier” servicer and originator of subprime mortgages, for \$706 million. Morgan Stanley’s stated purpose of the acquisition was to support its “strategy of building a global, vertically integrated residential mortgage business” and “further enhance [its] risk management of mortgage portfolios.” In addition, Morgan Stanley’s Institutional Services business increased its total exposure to variable interest entities (VIEs) – which includes mortgage-backed securities, CDOs and credit linked notes – from \$21.9 billion at November 30, 2005 to \$39.4 billion at November 30, 2006, an increase of 80%.

Morgan Stanley did apparently take steps to hedge its exposure in December 2006 after it reportedly gained access to market data through newly-acquired Saxon Capital. Those belated steps proved inadequate, however, prompting Moody’s Investors Service to raise “questions regarding the effectiveness of Morgan Stanley’s trading risk management.”

The consequences of Morgan Stanley's failure to sufficiently limit its exposure to a possible mortgage meltdown are increasingly evident. On December 19, 2007 the company stunned investors by announcing that a \$9.4 billion writedown in the fourth quarter relating to its subprime exposure, \$5.7 billion more than the company had warned only five weeks earlier. To soften the blow from the writedown, which represented an astounding 31 percent of the company's tangible common equity at August 31, 2007, the company simultaneously announced the sale of \$5 billion in mandatory convertible securities to the China Investment Corp. While this sale provided a desperately needed cash infusion, it comes at a high cost to existing shareholders, as it is expected to be dilutive to earnings by an estimated \$0.35 per share.

The firm's misread of market conditions in 2005 and 2006 has left shareholders questioning how Morgan Stanley could so systematically violate its own risk management principles of the "doctrine of no surprises" and "common sense is often paramount."

### **Where was the Audit Committee?**

While it is the CEO's job to manage Morgan Stanley's overall exposure to risk, it is the responsibility of the board's Audit Committee to review the firm's major financial risk and assess the steps management has taken to control such exposure. This duty is mandated by the NYSE listing requirements and defined in the Audit Committee's own charter. Moreover, while directors cannot be expected to understand every technical aspect of an underlying business, they still must acquire and maintain sufficient knowledge and understanding of the company's business to properly discharge their duty of care.

We believe that Morgan Stanley's Audit Committee failed in these duties as they relate to the company's exposure to mortgage-related risk in general and its investments in complex, mortgage-backed derivatives in particular. As *The New York Times* reported on December 21, 2007: "This year the leaders of some of the world's most respected financial institutions — leaders who are paid first and foremost to manage risk — have been caught either unaware or uninformed about giant risks their companies took. Their financial engineers concocted securities so complex that even the brainiacs cannot figure out what those investments are worth."

The Audit Committee's failure is especially troubling given the financial expertise of its individual members. As you know, three of the four current members qualify as financial experts under current Securities and Exchange Commission rules and would appear to have exactly the kind of experience shareholders expect to see on the audit committee of a major investment bank. You are a CPA and have served as the Chief Financial Officer of both Northrup Grumman and AT&T (where you also served as Vice Chairman). Howard J. Davies was Chairman of the UK's Financial Services Authority and Deputy Governor of the Bank of England. And Donald T. Nicolaisen is a former Chief Accountant of the SEC.

One factor may be that there has been significant turnover on the Audit Committee since John J. Mack replaced Phillip J. Purcell as Chairman and CEO in June of 2005. However, Mr. Davies and you have been on the board and its Audit Committee since 2004 and September 2005, respectively, and you became Audit Committee Chair in March, 2006. We believe Mr. Davies

and you are particularly culpable with regard to the company's poor risk mitigation in 2005 and 2006. Mr. Nicolaisen joined the Committee in April 2006 and may have also been in position to understand and rein in management's excessive risk taking in time to head off major losses. The final Committee member, Charles E. Phillips, Jr., joined in September 2006, too late in our view to bear any meaningful responsibility for the Committee's failure.

### **Morgan Stanley Shareholders Require a Detailed Explanation**

Commenting on the duties of effective boards in general, and audit committees in particular, you told Financial Executive magazine in May 2005 that, "Good boards have always been challenging and questioning positions and judgments of the management team – not in a hostile or confrontational fashion, but just being sure they understand what's going on," and noted that recently "A lot more attention is given to risk management and mitigation, with risk being defined quite broadly."

In preparation for Morgan Stanley's 2008 director election, we believe shareholders are entitled to a detailed explanation as to what steps Audit Committee members took, individually and collectively, to: (1) understand Morgan Stanley's exposure to mortgage risk, including through its investments in CDOs, SIVs and other exotic debt instruments; and (2) satisfy themselves that management was taking appropriate steps to control such exposure. Among the issues we would like Committee members to address:

- *Internal flow of information.* What information was routinely provided to you by management? How frequently was the information provided? Did the Committee request additional information from management in response to mounting concerns with mortgage-related risk? What additional information did the Committee request and when was it requested?
- *Utilization of Management's Risk Committee.* Morgan Stanley appears to have a designated management risk committee ("Firm Risk Committee") composed of senior executives and currently overseen by Thomas Daula, the firm's Chief Risk Officer. How was the Firm Risk Committee utilized by the Board's Audit Committee in 2005 and 2006? Did the Audit Committee meet regularly with the senior executives at the company with direct responsibility for measuring, analyzing and managing risk? How often did these meetings take place? Who was present at these meetings?
- *Independent assessment of information.* What independent steps did the Committee take to evaluate the information provided by management? Third-party advisors can serve as an important tool for directors to assess the quality of information they are receiving in the boardroom. Which, if any, outside firms were used by the Committee? When were they hired and what role did they play?
- *Committee deliberations and actions.* What additional actions, if any, did the Committee require management to take to control Morgan Stanley's significant mortgage-related exposure? We are particularly interested in deliberations and actions with respect to risk

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assessment, internal valuation models and hedging strategies. When did these actions occur?

We are not seeking an exhaustive set of documentation, but rather a cogent description of specific steps that you, as an incumbent director on the committee responsible for risk oversight, took to independently and pro-actively protect the interests of Morgan Stanley shareholders from excessive exposure to mortgage risk. We have made similar requests to Messrs Davies and Nicolaisen.

We look forward to a timely response so that shareholders can properly assess the suitability of your candidacy.

Sincerely,

A handwritten signature in black ink that reads "William Patterson". The signature is written in a cursive, slightly slanted style.

William Patterson  
Executive Director

Cc: John J. Mack, Chairman of the Board  
Laura D. Tyson, Chair, Nominating and Corporate Governance Committee