

CtW Investment Group

Selections from proxy advisors' reports on Morgan Stanley AGM March 31, 2008

In the wake of Board-level risk management failures, the CtW Investment Group has urged Morgan Stanley shareholders to vote against director nominees Howard Davies, Robert Kidder and John Mack at Morgan Stanley's April 8 Annual Meeting.

Last week, the major proxy advisers released their recommendations. RiskMetrics/ISS, believing that "shareholders would be well served by more independence and accountability in the board room," urged the Morgan Stanley Board "to consider appointing an independent chair," but stopped short of recommending votes against Davies, Kidder and Mack.

Glass Lewis and Proxy Governance, meanwhile, concluded that the board failures were sufficiently serious to warrant votes against former and/or current members of the Morgan Stanley audit committee. ISS Taft Hartley Advisory Services, meanwhile, found the risk management failures and lack of board independence sufficient to warrant votes against Directors Kidder, Davies and Mack, as well as others.

The following are key excerpts from their respective reports:

Glass Lewis (recommending votes AGAINST Davies, Kidder and others)

In our view... having risk managers report to the head of the Company's profit-driven business unit presents potential conflicts that undermine their role of providing objective risk oversight.

Nominees DAVIES [and] KIDDER ... served on the audit committee during periods in which the committee failed to adequately oversee the Company's risk controls following significant changes in the Company's business strategy to increase trading using its own capital and engage in aggressive risk-taking measures upon Mr. Mack's appointment as chairman and CEO in June 2005.

... we believe shareholders should hold the members of the audit committee since 2005 accountable for failing to ensure that the Company's risk controls were robust enough to prevent or mitigate its exposure to the subprime-related trading positions that led to the large writedowns, particularly in light of the audit committee charter provision indicating that the audit committee was responsible for that very oversight.

Proxy Governance (Recommending vote AGAINST Kidder)

... it appears to us that, in 2005, a critical risk management decision was made to change the reporting line of the CRO without formal approval or even review by the Audit Committee....Although management states that the committee "would have known" about the CRO reporting change, apparently such a review did not take place. We view this as a failure of Kidder, the senior member and chairman of the Audit Committee at that time.

We note that in 2006, the company created a lead director position, at least partially for the purpose of providing ... an independent voice on the board.... However, we question whether Kidder, who is the longest-tenured director on the board and who we believe has failed to exercise proper oversight of the company's risk management function in the past, is really the best person for the role.

PROXY *Governance's* analysis...suggest[s] failures on the part of the 2005 Audit Committee, which has responsibility for board level oversight of the company's risk management. We therefore recommend that shareholders vote against the re-election of C. Kidder, who chaired the Audit Committee at that time and currently serves as lead director, as a way to signal to the board the need to emphasize and elevate board-level oversight of the company's risk management function.

Risk Metrics/ISS (recommending votes FOR the entire board)

There is little question that the change in CRO reporting line clearly represented a departure from [enterprise risk management] best practices.

... While we agree that mistakes were made and some warning signs were ignored, there is no evidence that wholesale lapses in controls were resident at the firm.

Messrs. Davies, Kidder and the board missed some early warning signals and let a trading strategy with extreme consequences slip by. But they have demonstrated effective management by taking action on those responsible and tightening controls where the lapses took place.

... We also raise the bigger question of board independence, and on this issue, we believe CtW has appropriately identified an area of concern. ...Mr. Mack holds both roles as Chair and CEO, and as such, the combined role may hold too much influence over a board that was largely formed under the CEO's purview. Therefore, we agree with CtW that shareholders would be well served by more independence and accountability in this boardroom. ... We urge the board to consider appointing an independent Chair. Shareholders would be well served by additional accountability and independence in the board room, and progress towards that end, including the appointment of an independent Chair, would be a step in the right direction.

ISS Taft Hartley Services (recommending votes AGAINST Directors Davies, Kidder, Mack and others)

... we feel that by not participating in the severing of the best practice CRO-to-CEO reporting line, the audit committee effectively failed to act as an appropriate check to Mr. Mack's influence and decision-making at the time, and, thus, failed to fully protect shareholders' interests in its oversight of risk management at Morgan Stanley. Moreover, the audit committee should have recognized and perhaps more fully appreciated the conflict of interest inherent in the CRO reporting line to Ms. Cruz, notwithstanding the CRO's appointment to the management committee and the audit committee's access to the CRO.

...it has been widely reported that a singular desk's losses represented 23% of the firm's capital. The sheer magnitude of these losses and the fact that they occurred at just one

desk is astounding and persuasively underscores the need for stronger risk management superintendence especially within risk-heavy business lines such as proprietary trading.

On the broader question of board independence, we believe CtW has appropriately identified an area of legitimate concern. It is apparent that Mr. Mack exerts a considerable amount of influence as both the Chief Executive and board Chair at Morgan Stanley. His decision to change the CRO reporting structure without formal review or approval by the board or audit committee, and his strategy to promote risk taking without a demonstrably grounded and robust risk management program in place is an indication of the concentration of power vested in the combined leadership role.

... we will vote AGAINST Messrs. Kidder and Davies for failing to exercise independent risk management oversight and for failing to ensure that appropriate and robust risk management controls were present at Morgan Stanley. In this context, Kidder and Davies failed in their responsibilities to adequately minimize risk exposure and, thus, protect shareholder value. The vote AGAINST Mr. Mack as board Chair is aimed at improving independence and accountability in the boardroom. We believe that shareholders would best be served by Mr. Mack stepping down as Chairman and subsequently, by the appointment of a new independent Chairman.