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**UNITED STATES DISTRICT COURT  
CENTRAL DISTRICT OF CALIFORNIA  
SOUTHERN DIVISION**

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SOUTHERN DIVISION

20 JOEL STRATTE-McCLURE, STATE- )  
BOSTON RETIREMENT SYSTEM and, )  
21 FJÅRDE AP FONDEN, Individually and on )  
behalf of all others similarly situated, )  
22 )  
Plaintiffs, )  
23 )  
vs. )  
24 )  
MORGAN STANLEY, a Delaware )  
25 corporation, JOHN J. MACK, ZOE CRUZ, )  
DAVID SIDWELL, THOMAS COLM )  
26 KELLEHER, THOMAS V. DAULA, and )  
GARY G. LYNCH, )  
27 )  
Defendants. )

Case No.: CV08-963 AG (FFMx)

CLASS ACTION  
Honorable Andrew J. Guilford  
AMENDED CLASS ACTION  
COMPLAINT

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

19 **I. SUMMARY OF CLAIMS**

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

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

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

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

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

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

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

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

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

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

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

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

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

16 12. Defendants’ affirmative public statements, coupled with the absence of disclosures  
17 regarding the Company’s positioning with respect to the U.S. subprime market, caused analysts,  
18 investors and ratings agencies to believe that the Company’s subprime mortgage-related exposure  
19 was controlled and that Morgan was well-positioned, compared to its peers, to escape from the  
20 mortgage market meltdown relatively unscathed. For example, on March 21, 2007, Keefe,  
21 Bruyette & Woods analyst Lauren Smith raised her 2007 earnings estimate for the Company to  
22 \$8.12 from \$7.20. In doing so, Smith stated she believed the Company would “more than stand up  
23 to the perils we are witnessing in the sub prime mortgage market.” Smith also pointed out that  
24 “[m]anagement noted they feel very confident in how they are positioned and their exposures to the  
25 sub prime mortgage markets.” This was the total mix of information provided to the investing  
26 public leading up to the commencement of the Class Period.

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

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

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

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

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

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

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

10 18. The fair value of the Proprietary Trading Group's \$13.2 billion notional position, as  
11 Defendants would ultimately concede, was tied to the movement of an index called the ABX Index,  
12 which tracked the cost of insuring various tranches of residential mortgage backed securities. In  
13 particular, the fair value of the position was tied to the movement of the ABX Index for the BBB  
14 06-1 vintage, the ABX index that tracked the cost of insuring BBB rated mortgage backed  
15 securities originated in the second half of 2005. These were the exact CDSs that Morgan had sold.

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

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

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

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

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

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

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

