BEAR STEARNS COMPANIES INC
Form 10-Q/A
April 10, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q/A

Amendment No. 1

[X] Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended February 28, 2007

or

[_] Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from ___________ to ___________

Commission file number 1-8989

The Bear Stearns Companies Inc.
(Exact name of registrant as specified in its charter)

Delaware	13-3286161
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

383 Madison Avenue, New York, New York 10179
(Address of Principal Executive Offices) (Zip Code)

(212) 272-2000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [_]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. Large Accelerated Filer [X] Accelerated Filer [_] Non-Accelerated Filer [_]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [_] No [X]

As of April 5, 2007, the latest practicable date, there were 119,033,628 shares of Common Stock, $1 par value, outstanding.

EXPLANATORY NOTE

This amended Quarterly Report on Form 10-Q/A corrects typographical errors included on the tables appearing on pages 14 and 15.

TABLE OF CONTENTS

AVAILABLE INFORMATION

The Bear Stearns Companies Inc. and its subsidiaries ("Company") files current, annual and quarterly reports, proxy statements and other information required by the Securities Exchange Act of 1934, as amended ("Exchange Act"), with the Securities and Exchange Commission ("SEC"). You may read and copy any document the Company files at the SEC's public reference room located at 100 F Street, NE, Room 1580, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. The Company's SEC filings are also available to the public from the SEC's internet site at http://www.sec.gov. Copies of these reports, proxy statements and other information can also be inspected at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005.

The Company's public internet site is http://www.bearstearns.com. The Company makes available free of charge through its internet site, via a link to the SEC's internet site at http://www.sec.gov, its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and Forms 3, 4 and 5 filed on behalf of directors and executive officers and any amendments to those reports filed or furnished pursuant to the Exchange Act, as soon as reasonably practicable after it electronically files such material with, or furnishes it to, the SEC.

In addition, the Company currently makes available on http://www.bearstearns.com its most recent annual report on Form 10-K, its quarterly reports on Form 10-Q for the current fiscal year and its most recent proxy statement, although in some cases these documents are not available on that site as soon as they are available on the SEC's internet site. Also posted on the Company's website, and available in print upon request of any stockholder to the Investor Relations Department, are charters for the Company's Audit Committee, Compensation Committee, Corporate Governance Committee, Nominating Committee and Qualified Legal Compliance Committee. Copies of the Corporate Governance Guidelines and the Code of Business Conduct and Ethics governing our directors, officers and employees are also posted on the Company's website within the "Corporate Governance" section under the heading "About Bear Stearns." You will need to have the Adobe Acrobat Reader software on your computer to view these documents, which are in the .PDF format.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

THE BEAR STEARNS COMPANIES INC.
Condensed Consolidated Statements of
Income

(in thousands, except share and per share data)	(Unaudited) Three Months Ended February 28, 2007	February 28, 2006
REVENUES		
Commissions	$ 280,645	$ 286,071
Principal transactions	1,342,377	1,150,432
Investment banking	350,179	337,853
Interest and dividends	2,657,193	1,723,989
Asset management and other income	167,345	140,073
Total revenues	4,797,739	3,638,418
Interest expense	2,315,967	1,453,215
Revenues, net of interest expense	2,481,772	2,185,203
NON-INTEREST EXPENSES		
Employee compensation and benefits	1,204,094	1,046,850
Floor brokerage, exchange and clearance fees	56,085	51,243
Communications and technology	127,908	104,034
Occupancy	56,745	44,627
Advertising and market development	37,073	34,673
Professional fees	71,866	53,873
Other expenses	92,795	97,550
Total non-interest expenses	1,646,566	1,432,850
Income before provision for income taxes	835,206	752,353
Provision for income taxes	281,465	238,197
Net income	$ 553,741	$ 514,156
Preferred stock dividends	5,257	5,414
Net income applicable to common shares	$ 548,484	$ 508,742
Basic earnings per share	$ 4.23	$ 3.92
Diluted earnings per share	$ 3.82	$ 3.54
Weighted average common shares outstanding:		
Basic	133,094,747	132,738,565
Diluted	149,722,654	149,417,369
Cash dividends declared per common share	$ 0.32	$ 0.28

See Notes to Condensed Consolidated Financial Statements.

THE BEAR STEARNS COMPANIES INC.
Condensed Consolidated Statements of
Financial Condition

(in thousands, except share data)	(Unaudited) February 28, 2007	November 30, 2006
ASSETS		
Cash and cash equivalents	$ 5,891,313	$ 4,595,184
Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations	9,125,941	8,803,684
Securities purchased under agreements to resell	37,247,992	38,838,279
Securities received as collateral	21,227,351	19,648,241
Securities borrowed	84,014,630	80,523,355
Receivables:		
Customers	32,529,683	29,481,799
Brokers, dealers and others	7,307,621	6,119,348
Interest and dividends	892,799	744,542
Financial instruments owned, at fair value	134,410,336	109,200,487
Financial instruments owned and pledged as collateral, at fair value	12,754,203	15,967,964
Total financial instruments owned, at fair value	147,164,539	125,168,451
Assets of variable interest entities and mortgage loan special purpose entities	41,482,566	30,303,275
Property, equipment and leasehold improvements, net of accumulated depreciation and amortization of $1,192,106 and $1,152,279 as of February 28, 2007 and November 30, 2006, respectively	508,227	479,637
Other assets	7,119,263	5,726,800
Total Assets	$394,511,925	$350,432,595
LIABILITIES AND STOCKHOLDERS' EQUITY		
Short-term borrowings	$ 32,229,638	$29,062,714
Securities sold under agreements to repurchase	88,568,018	69,749,675
Obligation to return securities received as collateral	21,227,351	19,648,241
Securities loaned	12,147,665	11,451,324
Payables:		
Customers	77,892,685	72,988,661
Brokers, dealers and others	3,091,839	3,396,835
Interest and dividends	1,149,446	1,123,348
Financial instruments sold, but not yet purchased, at fair value	42,279,250	42,256,544
Liabilities of variable interest entities and mortgage loan special purpose entities	39,648,893	29,079,552
Accrued employee compensation and benefits	926,539	2,895,047
Other liabilities and accrued expenses	3,582,195	2,081,354
Long-term borrowings	58,494,473	54,569,916

Total Liabilities	$381,237,992	$338,303,211
Commitments and contingencies (Note 10)		
STOCKHOLDERS' EQUITY		
Preferred stock	359,156	359,156
Common stock, $1.00 par value; 500,000,000 shares authorized and 184,805,847 shares issued as of both February 28, 2007 and November 30, 2006	184,806	184,806
Paid-in capital	4,902,662	4,578,972
Retained earnings	9,894,928	9,384,595
Employee stock compensation plans	2,736,236	2,221,997
Unearned compensation	(193,216)	(155,596)
Treasury stock, at cost:		
Common stock: 65,192,031 and 67,396,876 shares as of February 28, 2007 and November 30, 2006, respectively	(4,610,639)	(4,444,546)
Total Stockholders' Equity	13,273,933	12,129,384
Total Liabilities and Stockholders' Equity	$394,511,925	$350,432,595

See Notes to Condensed Consolidated Financial Statements.

5

THE BEAR STEARNS COMPANIES INC.
Condensed Consolidated Statements of
Cash Flows

	(Unaudited) Three Months Ended	
(in thousands)	February 28, 2007	February 28, 2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 553,741	$ 514,156
Adjustments to reconcile net income to cash used in operating activities:		
Non-cash items included in net income:		
Depreciation and amortization	42,325	81,371
Deferred income taxes	(67,856)	(2,253)
Employee stock compensation plans	12,828	10,086
Changes in operating assets and liabilities:		
Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations	(322,257)	(1,513,965)
Securities borrowed, net of securities loaned	(2,794,934)	(9,074,155)
Receivables from customers	(3,047,884)	1,868,133
Receivables from brokers, dealers and others	(1,188,273)	1,533,983
Financial instruments owned	(22,957,905)	(4,222,328)
Other assets	(1,722,627)	(87,210)

Securities sold under agreements to repurchase, net of securities purchased under agreements to resell	20,408,630	6,473,250
Payables to customers	4,904,024	195,256
Payables to brokers, dealers and others	(304,996)	233,209
Financial instruments sold, but not yet purchased	(54,443)	(71,924)
Accrued employee compensation and benefits	(1,143,631)	(932,053)
Other liabilities and accrued expenses	1,525,208	(17,358)
Cash used in operating activities	(6,158,050)	(5,011,802)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property, equipment and leasehold improvements	(67,271)	(39,234)
Cash used in investing activities	(67,271)	(39,234)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from short-term borrowings	3,166,924	1,563,266
Proceeds from issuance of long-term borrowings	8,082,023	4,940,564
Payments for retirement/repurchase of long-term borrowings	(3,554,476)	(2,198,314)
Proceeds from issuances of derivatives with a financing element, net	77,149	74,600
Issuance of common stock	62,450	109,715
Cash retained resulting from tax deductibility under share-based payment arrangements	205,055	274,076
Redemption of preferred stock	-	(5,393)
Treasury stock purchases - common stock	(473,203)	(476,427)
Cash dividends paid	(44,472)	(38,766)
Cash provided by financing activities	7,521,450	4,243,321
Net increase/ (decrease) in cash and cash equivalents	1,296,129	(807,715)
Cash and cash equivalents, beginning of year	4,595,184	5,859,133
Cash and cash equivalents, end of period	$ 5,891,313	$ 5,051,418

Supplemental Disclosure of Cash Flow Information:

Cash payments for interest were $2.51 billion and $1.51 billion during the three months ended February 28, 2007 and 2006, respectively.

Cash payments for income taxes, net of refunds, were $108.8 million and $88.4 million for the three months ended February 28, 2007 and 2006, respectively. Cash payments for taxes, net of refunds, would have been $313.9 and $362.5 for the three months ended February 28, 2007 and 2006, respectively, if increases in the value of equity instruments issued under share-based payment arrangements had not been deductible in determining taxable income.

Note: Certain prior period amounts have been reclassified to conform to the current period's presentation.

See Notes to Condensed Consolidated Financial Statements.

THE BEAR STEARNS COMPANIES INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

The Bear Stearns Companies Inc. (the "Company") is a holding company that, through its broker-dealer and international bank subsidiaries, principally Bear, Stearns & Co. Inc. ("Bear Stearns"), Bear, Stearns Securities Corp. ("BSSC"), Bear, Stearns International Limited ("BSIL") and Bear Stearns Bank plc ("BSB"), is primarily engaged in business as a securities broker-dealer and operates in three principal segments: Capital Markets, Global Clearing Services and Wealth Management. Capital Markets is comprised of the institutional equities, fixed income and investment banking areas. Global Clearing Services provides clearance-related services for prime brokerage clients and clearance on a fully disclosed basis for introducing broker-dealers. Wealth Management is comprised of the private client services ("PCS") and asset management areas. See Note 12, "Segment and Geographic Area Data," in the Notes to Condensed Consolidated Financial Statements for a complete description of the Company's principal segments. The Company also conducts significant activities through other wholly owned subsidiaries, including: Bear Stearns Global Lending Limited; Custodial Trust Company; Bear Stearns Financial Products Inc.; Bear Stearns Capital Markets Inc.; Bear Stearns Credit Products Inc.; Bear Stearns Forex Inc.; EMC Mortgage Corporation; Bear Stearns Commercial Mortgage, Inc.; and through its majority-owned subsidiary Bear Hunter Holdings LLC. The Company participates, through Bear Hunter Holdings LLC, in specialist activities on the New York Stock Exchange ("NYSE"), American Stock Exchange ("AMEX") and International Securities Exchange ("ISE").

Basis of Presentation

The Condensed Consolidated Financial Statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling interest. Additionally, in accordance with Financial Accounting Standards Board ("FASB") Interpretation ("FIN") No. 46 (R), "Consolidation of Variable Interest Entities (revised December 2003)--an interpretation of Accounting Research Bulletin ("ARB") No. 51" ("FIN No. 46 (R)"), the Company also consolidates any variable interest entities ("VIEs") for which it is the primary beneficiary. The assets and related liabilities of such variable interest entities have been shown in the Condensed Consolidated Statements of Financial Condition in the captions "Assets of variable interest entities and mortgage loan special purpose entities" and "Liabilities of variable interest entities and mortgage loan special purpose entities." See Note 5, "Variable Interest Entities and Mortgage Loan Special Purpose Entities," in the Notes to Condensed Consolidated Financial Statements.

As of December 1, 2006, the Company has fully adopted Emerging Issues Task Force ("EITF") Issue No. 04-5 "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." The EITF consensus requires a general partner in a limited partnership to consolidate the limited partnership unless the presumption of control is overcome. The general partner may overcome this presumption of control and not consolidate the entity if the limited partners have: (a) the substantive ability to dissolve or liquidate the limited partnership or otherwise remove the general partner without having to show cause; or (b) substantive participating rights in managing the partnership.

When the Company does not have a controlling interest in an entity, but exerts significant influence over the entity's operating and financial decisions (generally defined as owning a voting or economic interest of 20% to 50%), the Company applies the equity method of accounting.

The Condensed Consolidated Statement of Financial Condition as of February 28, 2007, the Condensed Consolidated Statements of Income for the three months ended February 28, 2007 and February 28, 2006 and the Condensed Consolidated Statements of Cash Flows for the three months ended February 28, 2007 and February 28, 2006 are unaudited. The Condensed Consolidated Statement of Financial Condition at November 30, 2006 and related information was derived from the audited consolidated financial statements.

The Condensed Consolidated Financial Statements are prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") with respect to the Form 10-Q and reflect all adjustments which, in the opinion of management, are normal and recurring, and which are necessary for a fair statement of the results for the interim periods presented. In accordance with such rules and regulations, certain disclosures that are normally included in annual financial statements have been omitted. These financial statements should be read together with the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2006, as filed by the Company under the Securities Exchange Act of 1934, as amended ("Exchange Act") (the "Form 10-K").

The Condensed Consolidated Financial Statements are prepared in conformity with accounting principles generally accepted in the United States of America. These principles require management to make certain estimates and assumptions, including those regarding inventory valuations, stock-based compensation, certain accrued liabilities and the potential outcome of litigation and tax matters, which may affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Actual results could differ materially from these estimates. The nature of the Company's business is such that the results of any interim period may not be indicative of the results to be expected for an entire fiscal year. All material intercompany transactions and balances have been eliminated in consolidation. Certain prior period amounts have been reclassified to conform to the current period's presentation.

Financial Instruments

Proprietary securities, futures and other derivative transactions are recorded on a trade date basis. Financial instruments owned and financial instruments sold, but not yet purchased, including contractual commitments arising pursuant to futures, forward and option contracts, interest rate swaps and other derivative contracts, are recorded at fair value with the resulting net unrealized gains and losses reflected in "Principal

Transactions" revenues in the Condensed Consolidated Statements of Income.

The Company adopted Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements," in the 2007 quarter. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. Additionally, SFAS No. 157 disallows the use of block discounts on positions traded in an active market as well as nullifies certain guidance in EITF No. 02-3 regarding the recognition of inception gains on certain derivative transactions. See Note 2 of Notes to Condensed Consolidated Financial Statements for a complete discussion on SFAS No. 157.

Fair value is generally based on quoted market prices. If quoted market prices are not available, fair value is determined based on other relevant factors, including dealer price quotations, price activity for equivalent instruments and valuation pricing models. Valuation pricing models consider time value, yield curve and volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other measurements.

Equity interests and securities acquired as a result of private equity and merchant banking activities are reflected in the Condensed Consolidated Financial Statements at fair value, which is often represented as initial cost until significant transactions or developments indicate that a change in the carrying value of the securities is appropriate. This represents the Company's best estimate of exit price as defined by SFAS No. 157. Generally, the carrying values of these securities will be increased based on company performance and in those instances where market values are readily ascertainable by reference to substantial transactions occurring in the marketplace or quoted market prices. Reductions to the carrying value of these securities are made when the Company's estimate of net realizable value has declined below the carrying value.

Derivative Instruments and Hedging Activities

The Company follows SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," and SFAS No.

8

149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which establishes accounting and reporting standards for stand-alone derivative instruments, derivatives embedded within other contracts or securities, and hedging activities. Accordingly, all derivatives, whether stand-alone or embedded within other contracts or securities (except in narrowly defined circumstances), are carried in the Company's Condensed Consolidated Statements of Financial Condition at fair value, with changes in fair value recorded in current earnings in "Principal Transactions" revenues. Designated hedged items in fair value hedging relationships are marked for the risk being hedged, with such changes recorded in current earnings.

On December 1, 2006, the Company adopted SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments--an amendment of FASB Statements No. 133 and 140." SFAS No. 155 permits companies to elect on an instrument-by-instrument basis, to apply a fair value measurement to hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation under SFAS No. 133. As permitted, on December 1, 2006, the Company elected to apply a fair value measurement to all existing hybrid financial instruments that met the SFAS No. 155 definition. The Company also elected the fair value measurement for all qualifying hybrid financial instruments issued on or after December 1, 2006. The Company's primary reason for electing to carry these instruments on a fair value basis was to enable the Company to more efficiently hedge these instruments and to simplify the accounting process. The hybrid instruments are reported as a component of "Other liabilities" in the Fair Value Measurements disclosure. The transition adjustment related to the adoption of SFAS No. 155 did not have a material impact on the Condensed Consolidated Financial Statements of the Company.

The Company follows FIN No. 39, "Offsetting Amounts Related to Certain Contracts," and offsets assets and liabilities in the Condensed Consolidated Statements of Financial Condition provided that the legal right of offset exists under a master netting agreement. This includes the offsetting of payables or receivables relating to the fair value of cash collateral received or paid associated with its derivative inventory, on a counterparty basis.

Customer Transactions

Customer securities transactions are recorded on the Condensed Consolidated Statements of Financial Condition on a settlement date basis, which is generally three business days after trade date, while the related commission revenues and expenses are recorded on a trade date basis. Receivables from and payables to customers include amounts related to both cash and margin transactions. Securities owned by customers, including those that collateralize margin or other similar transactions, are generally not reflected in the Condensed Consolidated Statements of Financial Condition.

Mortgage Servicing Assets, Fees and Advances

Mortgage servicing rights ("MSRs") are included in "Other Assets" on the Condensed Consolidated Statements of Financial Condition. On December 1, 2006, the Company adopted SFAS No. 156, "Accounting for Servicing of Financial Assets--an amendment of FASB Statement No. 140," and elected to measure servicing assets at fair value. Fair value of MSRs is determined by using market-based models that discount anticipated future net cash flows considering loan prepayment predictions, interest rates, default rates, servicing costs, current market data and other economic factors. The adoption of SFAS No. 156 did not have a material impact on the Condensed Consolidated Financial Statements of the Company.

Contractual servicing fees, late fees and other ancillary servicing fees earned for servicing mortgage loans are reflected in "Investment Banking" revenues in the Condensed Consolidated Statements of Income. Contractual servicing fees are recognized when earned based on the terms of the servicing agreement. All other fees are recognized when received. In the normal course of its business, the Company makes principal, interest and other servicing advances to external investors on mortgage loans serviced for these investors. Such advances are generally recoverable from the mortgagors, related securitization trusts or from the proceeds received from the sales of the

underlying properties. A charge to earnings is recognized to the extent that servicing advances are estimated to be uncollectible under the provisions of the servicing contracts.

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

The Company follows SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities--a replacement of FASB Statement No. 125," to account for securitizations and other transfers of financial assets and collateral. SFAS No. 140 establishes accounting and reporting standards with a financial-components approach that focuses on control. Under this approach, financial assets or liabilities are recognized when control is established and derecognized when control has been surrendered or the liability has been extinguished. Control is deemed to be relinquished only when all of the following conditions have been met: (1) the assets have been isolated from the transferor, even in bankruptcy or other receivership; (2) the transferee is a Qualifying Special Purpose Entity ("QSPE") or has the right to pledge or exchange the assets received; and (3) the transferor has not maintained effective control over the transferred assets. The Company derecognizes financial assets transferred in securitizations provided that such transfer meets all of these criteria.

Mortgage securitization transactions, net of certain direct costs, are recorded in "Principal Transactions" revenues in the Condensed Consolidated Statements of Income.

Collateralized Securities Transactions

Transactions involving purchases of securities under agreements to resell ("reverse repurchase agreements") or sales of securities under agreements to repurchase ("repurchase agreements") are treated as collateralized financing transactions and are recorded at their contracted resale or repurchase amounts plus accrued interest. Resulting interest income and expense is generally included in "Principal Transactions" revenues in the Condensed Consolidated Statements of Income. Reverse repurchase agreements and repurchase agreements are presented in the Condensed Consolidated Statements of Financial Condition on a net-by-counterparty basis, where permitted by generally accepted accounting principles. It is the Company's general policy to take possession of securities with a market value in excess of the principal amount loaned plus the accrued interest thereon, in order to collateralize reverse repurchase agreements. Similarly, the Company is generally required to provide securities to counterparties to collateralize repurchase agreements. The Company's agreements with counterparties generally contain contractual provisions allowing for additional collateral to be obtained, or excess collateral returned. It is the Company's policy to value collateral and to obtain additional collateral, or to retrieve excess collateral from counterparties, when deemed appropriate.

Securities borrowed and securities loaned are recorded based upon the amount of cash collateral advanced or received. Securities borrowed transactions facilitate the settlement process and require the Company to deposit cash, letters of credit or other collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash or other collateral. The amount of collateral required to be deposited for securities borrowed, or received for securities loaned, is an amount generally in excess of the market value of the applicable securities borrowed or loaned. The Company monitors the market value of securities borrowed and loaned, with excess collateral retrieved or additional collateral obtained, when deemed appropriate.

Investment Banking and Advisory Services

Underwriting revenues and fees for mergers and acquisitions advisory services are accrued when services for the transactions are substantially completed. Transaction expenses are deferred until the related revenue is recognized. Investment banking and advisory services revenues are presented net of transaction-related expenses.

Commissions

Commission revenues primarily include fees from executing and clearing client transactions on stock, options and

futures markets worldwide. These fees are recognized on a trade-date basis. The Company records its share of the commission under certain commission sharing arrangements where the Company is acting as agent for another broker, in accordance with EITF Statement No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent."

Asset Management and Other Income

The Company receives advisory fees for investment management. In addition, the Company receives performance incentive fees for managing certain funds. Advisory fees are recognized over the period of advisory service. Unearned advisory fees are treated as deferred revenues and are included in "Other Liabilities" in the accompanying Condensed Consolidated Statements of Financial Condition. Performance incentive fees are recognized throughout the year as they become realizable based on achievement of specified performance targets.

Fixed Assets

Depreciation of property and equipment is provided by the Company on a straight-line basis over the estimated useful life of the asset. Amortization of leasehold improvements is provided on a straight-line basis over the lesser of the estimated useful life of the asset or the remaining life of the lease.

Goodwill and Identifiable Intangible Assets

The Company accounts for goodwill and identifiable intangible assets under the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets." In accordance with this guidance, the Company does not amortize goodwill, but amortizes identifiable intangible assets over their useful lives. Goodwill is tested at least annually for impairment and identifiable intangible assets are tested for potential impairment whenever events or changes in circumstances suggest that the carrying value of an asset or asset group may not be fully recoverable in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

Earnings Per Share

Earnings per share ("EPS") is computed in accordance with SFAS No. 128, "Earnings Per Share." Basic EPS is computed by dividing net income applicable to common shares, adjusted for costs related to vested shares under the Capital Accumulation Plan for Senior Managing Directors, as amended ("CAP Plan"), as well as the effect of the redemption of preferred stock, by the weighted average number of common shares outstanding. Common shares outstanding includes vested units issued under certain stock compensation plans, which will be distributed as shares of common stock. Diluted EPS includes the determinants of basic EPS and, in addition, gives effect to dilutive potential common shares related to stock compensation plans.

Stock-Based Compensation

The Company follows SFAS No. 123 (R), "Share-Based Payment," to account for its stock-based compensation plans. SFAS No. 123 (R) is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and amends SFAS No. 95, "Statement of Cash Flows." SFAS No. 123 (R) eliminated the ability to account for share-based compensation transactions in using APB No. 25, and requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements using a fair value-based method. The Company adopted SFAS No. 123 (R) effective December 1, 2005, using the modified prospective method. The Company previously elected to adopt fair value accounting for stock-based compensation consistent with SFAS No. 123, using the prospective method with guidance provided by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosures," effective December 1, 2002. As a result, commencing with options granted after November 30, 2002, the Company expensed the fair value of stock options issued to employees over the related vesting period.

Cash Equivalents

The Company has defined cash equivalents as liquid investments not held for sale in the ordinary course of business with original maturities of three months or less that are not part of the Company's trading inventory.

Income Taxes

The Company and certain of its subsidiaries file a US consolidated federal income tax return. The Company accounts for income taxes under the provisions of SFAS No. 109, "Accounting for Income Taxes." Under SFAS No. 109, deferred income taxes are based on the net tax effects of temporary differences between the financial reporting and tax bases of assets and liabilities. In addition, deferred income taxes are determined by the enacted tax rates and laws expected to be in effect when the related temporary differences are expected to be reversed.

The Company is under continuous examination by various tax authorities in jurisdictions in which the Company has significant business operations. The Company regularly evaluates the likelihood of additional assessments in each of the tax jurisdictions resulting from these examinations. Tax reserves have been established, which the Company believes to be adequate in relation to the probability for additional assessments. Once established, reserves are adjusted as information becomes available or when an event requiring a change to the reserve occurs.

Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at period end rates of exchange, while income statement items are translated at daily average rates of exchange during the fiscal period. Comprehensive income was materially the same as net income for the Company for the three months ended February 28, 2007 and 2006. Gains or losses resulting from foreign currency transactions are included in net income.

Accounting and Reporting Developments

During the 2007 quarter, the Company adopted SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments--an amendment of FASB Statements No. 133 and 140," SFAS No. 156, "Accounting for Servicing of Financial Assets--an amendment of FASB Statement No. 140," and SFAS No. 157, "Fair Value Measurements." As a result of the adoption of these standards, the Company recorded a cumulative effect adjustment to increase the opening retained earnings balance by approximately $3.5 million (after tax).

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109" ("FIN No. 48"). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company expects to adopt the provisions of FIN No. 48 beginning in the first quarter of 2008. The Company is currently evaluating the impact, if any, the adoption of FIN No. 48 may have on the Condensed Consolidated Financial Statements of the Company.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." SFAS No. 159 permits entities to choose to measure financial assets and liabilities (except for those that are specifically scoped out of the Statement) at fair value. The election to measure a financial asset or liability at fair value can be made on an instrument-by-instrument basis and is irrevocable. The difference between carrying value and fair value at the election date is recorded as a transition adjustment to opening retained earnings. Subsequent changes in fair value are recognized in earnings. The effective date for SFAS No. 159 is as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company will adopt SFAS No. 159 on December 1, 2007. The Company does not expect the adoption of SFAS No. 159 to have a material impact

12

on the Condensed Consolidated Financial Statements of the Company.

2. FINANCIAL INSTRUMENTS

Financial instruments owned and financial instruments sold, but not yet purchased, consisting of the Company's proprietary trading inventories, at fair value, were as follows:

(in thousands)	February 28, 2007	November 30, 2006
FINANCIAL INSTRUMENTS OWNED:		

U.S. government and agency	$ 5,246,453	$ 6,136,191
Other sovereign governments	2,456,191	1,371,713
Corporate equity and convertible debt	36,423,135	28,892,588
Corporate debt and other	35,208,016	33,924,116
Mortgages, mortgage- and asset-backed	57,549,272	43,226,699
Derivative financial instruments	10,281,472	11,617,144
	$ 147,164,539	$ 125,168,451
FINANCIAL INSTRUMENTS SOLD, BUT NOT YET PURCHASED:		
U.S. government and agency	$ 10,736,633	$ 11,724,095
Other sovereign governments	3,900,955	1,275,145
Corporate equity and convertible debt	12,408,671	12,623,291
Corporate debt and other	5,062,733	4,714,019
Mortgages, mortgage- and asset-backed	35,320	54,802
Derivative financial instruments	10,134,938	11,865,192
	$ 42,279,250	$ 42,256,544

Note: Certain prior period amounts have been reclassified to conform to the current period's presentation.

As of February 28, 2007 and November 30, 2006, all financial instruments owned that were pledged to counterparties where the counterparty has the right, by contract or custom, to rehypothecate those securities are classified as "Financial instruments owned and pledged as collateral" in the Condensed Consolidated Statements of Financial Condition.

Financial instruments sold, but not yet purchased, represent obligations of the Company to purchase the specified financial instrument at the then current market price. Accordingly, these transactions result in off-balance-sheet risk as the Company's ultimate obligation to repurchase such securities may exceed the amount recognized in the Condensed Consolidated Statements of Financial Condition.

Concentration Risk

The Company is subject to concentration risk by holding large positions or committing to hold large positions in certain types of securities, securities of a single issuer (including governments), issuers located in a particular country or geographic area, or issuers engaged in a particular industry. Positions taken and commitments made by the Company, including underwritings, often involve substantial amounts and significant exposure to individual issuers and businesses, including non-investment-grade issuers. At February 28, 2007 and November 30, 2006, the Company's most significant concentrations were related to US government and agency inventory positions, including those of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. In addition, a substantial portion of the collateral held by the Company for reverse repurchase agreements consists of securities issued by the US government and agencies.

Fair Value Measurements

The Company has adopted SFAS No. 157, "Fair Value Measurements," in the first quarter of 2007. SFAS No. 157 applies to all financial instruments that are being measured and reported on a fair value basis. This includes those items currently reported in "Financial instruments owned" and "Financial instruments sold, but not yet purchased" on the Condensed Consolidated Statements of Financial Condition as well as financial instruments reported in "Other assets" and "Other liabilities" that are reported at fair value.

As defined in SFAS No. 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Company uses various methods including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable firm inputs. The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Based on the observability of the inputs used in the valuation techniques the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.
Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.
Level 3: Unobservable inputs that are not corroborated by market data.

Level 1 primarily consists of financial instruments whose value is based on quoted market prices such as exchange-traded derivatives and listed equities. Additionally, this category also includes those financial instruments that are typically valued using alternative approaches but for which the Company typically receives independent external valuation information including US Treasuries, other US Government and agency securities, as well as certain corporate debt securities.

Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including time value, yield curve, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Financial instruments in this category include non-exchange-traded derivatives such as interest rate swaps, certain mortgage-backed securities and certain other cash instruments.

Level 3 is comprised of financial instruments whose fair value is estimated based on internally developed models or methodologies utilizing significant inputs that are generally less readily observable from objective sources. Included in this category are non-performing mortgage-related assets, certain residual interests, Chapter 13 and other credit card receivables from individuals, complex derivatives which can be long-dated equity derivatives, certain credit and municipal derivatives and other exotic derivative structures.

In determining the appropriate levels, the firm performs a detailed analysis of the assets and liabilities that are subject to SFAS No. 157. At each reporting period, all assets and liabilities for which the fair value measurement is based on significant unobservable inputs are classified as Level 3.

Assets at Fair Value as of February 28, 2007

(in thousands)	Level 1	Level 2	Level 3	Impact of Netting
Financial Instruments Owned				
Non-Derivative Trading Inventory	$ 29,673,936	$ 96,154,346	$ 11,054,785	$ --
Derivative Trading Inventory(1)	1,036,310	62,866,804	4,585,611	(58,207,253)
Total Financial Instruments Owned	30,710,246	159,021,150	15,640,396	(58,207,253)
Other Assets	98,748	759,222	3,322,443	--
Total Assets at Fair Value	$ 30,808,994	$159,780,372	$ 18,962,839	$(58,207,253)

Liabilities at Fair Value as of February 28, 2007

(in thousands)	Level 1	Level 2	Level 3	Impact of Netting
Financial Instruments Sold, But Not Yet Purchased				
Non-Derivative Trading Inventory	$ 23,839,863	$ 8,090,224	$ 214,225	$ --
Derivative Trading Inventory	1,000,611	59,292,575	6,519,500	(56,677,748
Total Financial Instruments Sold, But Not Yet Purchased	24,840,474	67,382,799	6,733,725	(56,677,748
Other Liabilities	--	7,213,491	2,208,342	--
Total Liabilities at Fair Value	$ 24,840,474	$ 74,596,290	$ 8,942,067	$(56,677,748

(1) Derivative contracts are reported on a gross basis by level. The impact of netting represents an adjustment related to cash collateral and counterparty netting.

14

As stated above SFAS No. 157 applies to all financial assets and liabilities that are reported on a fair value basis. These valuations are adjusted for various factors including credit risk. For applicable financial assets carried at fair value, the credit standing of the counterparties is analyzed and factored into the fair value measurement of those assets. SFAS No. 157 states that the fair value measurement of a liability must reflect the nonperformance risk of the entity. Therefore, the impact of credit standing as well as any potential credit enhancements (e.g. collateral) has been factored into the fair value measurement of both financial assets and liabilities.

The non-derivative trading inventory category includes securities such as US Government and agency, other sovereign governments, corporate equities, convertible debt, corporate debt, mortgages, mortgage- and asset-backed, as well as certain other items. They are reported in "Financial instruments owned" and "Financial instruments sold, but not yet purchased" on the Condensed Consolidated Statements of Financial Condition. The derivatives trading inventory balances in the table above are reported on a gross basis by level with a netting adjustment presented separately in the "Impact of Netting" column. The Company often enters into different types of derivative contracts with a single counterparty and these contracts are covered under one ISDA master netting agreement. The fair value of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy.

Other assets and other liabilities represent those financial assets and liabilities that the Company carries at fair value but are not included in "Financial instruments owned" and "Financial instruments sold, but not yet purchased" captions. Other assets includes certain items such as alternative investments, mortgage servicing rights, assets of VIEs and mortgage securitizations that did not meet the criteria for sale treatment under SFAS No. 140. Other liabilities is primarily comprised of certain hybrid debt issuances accounted for at fair value as elected in accordance with SFAS No. 155.

The following table provides a reconciliation of the beginning and ending balances for the major classes of assets and liabilities measured at fair value using significant unobservable inputs (level 3):

Level 3 Financial Assets and Liabilities
3 Months ended February 28, 2007

(in thousands)	Balance as of November 30, 2006	Total gains and losses (Realized and Unrealized)	Purchases, Issuances, Sales, Settlements	Transfers In or Out of Level 3
Non-Derivative Trading Assets	$ 8,999,658	$ (182,452)	$ 1,008,568	$ 1,229,011
Non-Derivative Trading Liabilities	(190,141)	114,048	(153,460)	15,328
Derivative Trading Inventory (Net)	(2,223,112)	(328,863)	57,779	560,307
Other Assets	2,836,060	25,129	348,358	112,896
Other Liabilities	(3,514,847)	38,875	941,508	326,122

Total gains or losses represent the total (realized and unrealized) gains and losses recorded for the Level 3 assets and liabilities and are primarily reported in "Principal Transactions" revenues in the Condensed Consolidated Statements of Income.

Purchases, issuances, sales and settlements represent Level 3 assets and liabilities that were either purchased, issued, sold, or settled during the period. The amounts are recorded at their end of period fair values.

Transfers in and/or out represents existing assets or liabilities that were either previously categorized as a higher level and the inputs to the model became unobservable or assets and liabilities that were previously classified as Level 3 and the lowest significant input became observable during the period. These assets and liabilities are recorded at their end of period fair values.

The amount of unrealized gains and losses included in earnings attributable to the change in unrealized gains and losses relating to assets or liabilities still held at the end of the period is reported in "Principal Transactions" revenues in the Condensed Consolidated Statements of Income. Additionally, the change in the unrealized gains and losses are often offset by realized gains and losses during the period. The risks or volatility associated with the transactions that make up this amount are often offset or reduced by certain hedging strategies. The Company regularly engages in hedging strategies in which financial instruments from different levels are used to economically hedge the risk of other financial instruments. The hedging and underlying financial instruments are often classified in different levels based on the Fair Value Hierarchy. Therefore, the unrealized gains and losses for the period from Level 3 assets and liabilities are often offset by unrealized gains and losses on positions classified in Levels 1 or 2 as well as positions that have been realized during the quarter.

3. DERIVATIVES AND HEDGING ACTIVITIES

The Company, in its capacity as a dealer in over-the-counter derivative financial instruments and its proprietary market-making and trading activities, enters into transactions in a variety of cash and derivative financial instruments for proprietary trading and to manage its exposure to market and credit risk. These risks include interest rate, exchange rate, equity price, and commodity price risk. Derivative financial instruments represent contractual commitments between counterparties that derive their value from changes in an underlying interest rate, currency exchange rate, index (e.g., Standard & Poor's 500 Index), reference rate (e.g., London Interbank Offered Rate, or LIBOR), or asset value referenced in the related contract. Some derivatives, such as futures contracts, certain options and index-referenced warrants, can be traded on an exchange. Other derivatives, such as interest rate and currency swaps, caps, floors, collars, swaptions, equity swaps and options, credit derivatives, structured notes and forward contracts, are negotiated in the over-the-counter markets. Derivatives generate both on- and off-balance-sheet risks depending on the nature of the contract. Generally, these financial instruments represent commitments or rights to exchange interest payment streams or currencies or to purchase or sell other securities at specific terms at specified future dates. Option contracts generally provide the holder with the right, but not the obligation, to

purchase or sell a financial instrument at a specific price on or before an established date or dates. Financial instruments sold, but not yet purchased may result in market and/or credit risk in excess of amounts recorded in the Condensed Consolidated Statements of Financial Condition.

Market Risk

Derivative financial instruments involve varying degrees of off-balance-sheet market risk, whereby changes in the level or volatility of interest rates, foreign currency exchange rates or market values of the underlying financial instruments may result in changes in the value of a particular financial instrument in excess of the amounts currently reflected in the Condensed Consolidated Statements of Financial Condition. The Company's exposure to market risk is influenced by a number of factors, including the relationships among and between financial instruments with off-balance-sheet risk, the Company's proprietary securities, futures and derivatives inventories as well as the volatility and liquidity in the markets in which the financial instruments are traded. The Company mitigates its exposure to market risk by entering into hedging transactions, which may include over-the-counter derivative contracts or the purchase or sale of interest-bearing securities, equity securities, financial futures and forward contracts. In this regard, the utilization of derivative instruments is designed to reduce or mitigate market risks associated with holding dealer inventories or in connection with arbitrage-related trading activities.

Derivatives Credit Risk

Credit risk arises from the potential inability of counterparties to perform in accordance with the terms of the contract. At any point in time, the Company's exposure to credit risk associated with counterparty non-performance is generally limited to the net replacement cost of over-the-counter contracts, net of the value of collateral held. Such financial instruments are reported at fair value on a net-by-counterparty basis pursuant to enforceable netting agreements. Exchange-traded financial instruments, such as futures and options, generally do not give rise to significant unsecured counterparty exposure due to the Company's margin requirements, which may be greater than those prescribed by the individual exchanges. Options written by the Company generally do not give rise to counterparty credit risk since they obligate the Company (not its counterparty) to perform.

The Company has controls in place to monitor credit exposures by assessing the future creditworthiness of counterparties and limiting transactions with specific counterparties. The Company also seeks to control credit risk by following an established credit approval process, monitoring credit limits and requiring collateral where appropriate.

Non-Trading Derivatives Activity

To modify the interest rate characteristics of its long- and short-term debt, the Company also engages in non-trading derivatives activities. The Company has issued US dollar- and foreign currency-denominated debt with both variable- and fixed-rate interest payment obligations. The Company has entered into interest rate swaps, primarily based on LIBOR, to convert fixed-rate interest payments on its debt obligations into variable-rate payments. In addition, for foreign currency debt obligations that are not used to fund assets in the same currency, the Company has entered into currency swap agreements that effectively convert the debt into US dollar obligations. Such transactions are accounted for as fair value hedges.

These financial instruments are subject to the same market and credit risks as those that are traded in connection with the Company's market-making and trading activities. The Company has similar controls in place to monitor these risks.

SFAS No. 133, as amended by SFAS No. 138 and SFAS No. 149, establishes accounting and reporting standards for stand-alone derivative instruments, derivatives embedded within other contracts or securities and for hedging activities. It requires that all derivatives, whether stand-alone or embedded within other contracts or securities (except in very defined circumstances) be carried on the Company's Condensed Consolidated Statement of

Financial Condition at fair value. SFAS No. 133 also requires items designated as being fair value hedged to be recorded at fair value, as defined in SFAS No. 133, provided that the intent to hedge is fully documented. Any resultant net change in value for both the hedging derivative and the hedged item is recognized in earnings immediately, such net effect being deemed the "ineffective" portion of the hedge. The gains and losses associated with the ineffective portion of the fair value hedges are included in "Principal transactions" revenues in the Condensed Consolidated Statements of Income. These amounts were immaterial for the three months ended February 28, 2007 and 2006.

On December 1, 2006, the Company adopted SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments--an amendment of FASB Statements No. 133 and 140." SFAS No. 155 permits companies to elect, on an instrument-by-instrument basis, to apply a fair value measurement to hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation under SFAS No. 133. As permitted, on December 1, 2006, the Company elected to apply a fair value measurement to all existing hybrid financial instruments that meet the SFAS No. 155 definition. The Company has also elected the fair value measurement for all qualifying hybrid financial instruments issued on or after December 1, 2006.

4. TRANSFERS OF FINANCIAL ASSETS AND LIABILITIES

Securitizations

The Company is a market leader in mortgage-backed securitization and other structured financing arrangements. In the normal course of business, the Company regularly securitizes commercial and residential mortgages, consumer receivables and other financial assets. Securitization transactions are generally treated as sales, provided that control has been relinquished. In connection with securitization transactions, the Company establishes special-purpose entities ("SPEs"), in which transferred assets, including commercial and residential mortgages, consumer receivables and other financial assets are sold to an SPE and repackaged into securities or similar beneficial interests. Transferred assets are accounted for at fair value prior to securitization. The majority of the Company's involvement with SPEs relates to securitization transactions meeting the definition of a QSPE under the provisions of SFAS

No. 140. Provided it has relinquished control over such assets, the Company derecognizes financial assets transferred in securitizations and does not consolidate the financial statements of QSPEs. For SPEs that do not meet the QSPE criteria, the Company uses the guidance in FIN No. 46 (R) to determine whether the SPE should be consolidated.

In connection with these securitization activities, the Company may retain interests in securitized assets in the form of senior or subordinated securities or as residual interests. Retained interests in securitizations are generally not held to maturity and typically are sold shortly after the settlement of a securitization. The weighted average holding period for retained interest positions in inventory at February 28, 2007 and November 30, 2006 was approximately 150 days. These retained interests are included in "Financial instruments owned" in the Condensed Consolidated Statements of Financial Condition and are carried at fair value. Consistent with the valuation of similar inventory, fair value is determined by broker-dealer price quotations and internal valuation pricing models that utilize variables such as yield curves, prepayment speeds, default rates, loss severity, interest rate volatilities and spreads. The assumptions used for pricing variables are based on observable transactions in similar securities and are further verified by external pricing sources, when available.

The Company's securitization activities are detailed below:

(in billions)	Agency Mortgage-Backed	Other Mortgage- and Asset-Backed	Total
Total securitizations			
Three months ended February 28, 2007	$4.7	$21.3	$26.0
Three months ended February 28, 2006	$5.8	$24.8	$30.6
Retained interests			
As of February 28, 2007	$1.9	$5.2	$7.1 (1)
As of November 30, 2006	$1.5	$4.1	$5.6 (2)

(1) Includes approximately $5.7 billion in investment-grade retained interests of which $3.8 billion is AAA rated.

(2) Includes approximately $4.3 billion in investment-grade retained interests of which $3.0 billion is AAA rated.

The following table summarizes cash flows from securitization trusts related to securitization transactions during the three months ended February 28, 2007 and 2006:

(in millions)	Agency Mortgage-Backed	Other Mortgage and Asset-Backed	Total
Cash flows received			

from retained interests			
Three months ended February 28, 2007	$13.5	$78.3	$91.8
Three months ended February 28, 2006	$21.1	$109.3	$130.4
Cash flows from servicing			
Three months ended February 28, 2007	-	$4.5	$4.5
Three months ended February 28, 2006	$ 0.1	$6.0	$6.1

The Company is an active market maker in these securities and therefore may retain interests in assets it securitizes, predominantly highly rated or government agency-backed securities. The models employed in the valuation of retained interests consider possible changes in prepayment speeds in response to changes in future interest rates, as well as potential credit losses. Prepayment speed changes are incorporated by calibrating to the observed levels of implied volatility in the market for interest rate options. Credit losses are considered through option-adjusted spreads that also incorporate additional factors such as liquidity and model uncertainty. The models use discount rates that are based on the Treasury curve, plus the option-adjusted spread. Key points on the constant maturity Treasury curve at February 28, 2007 were 4.64% for 2-year Treasuries and 4.63% for 10-year Treasuries, and ranged from 4.49% to 5.11%.

Weighted average key economic assumptions used in measuring the fair value of retained interests in assets the Company securitized at February 28, 2007 were as follows:

	Agency Mortgage-Backed	Other Mortgage- and Asset-Backed
Weighted average life (years)	6.6	4.7
Average prepayment speeds (annual rate)	8% - 40%	8% - 50%
Credit losses	-	0% - 24%

The following hypothetical sensitivity analysis as of February 28, 2007 illustrates the potential adverse change in fair value of these retained interests due to a specified change in the key valuation assumptions. The interest rate changes represent a parallel shift in the Treasury curve. This shift considers the effect of other variables, including prepayments. The remaining valuation assumptions are changed independently. Retained interests in securitizations are generally not held to maturity and are typically sold shortly after the settlement of a securitization. The Company considers the current and expected credit profile of the underlying collateral in determining the fair value and periodically updates the fair value for changes in credit, interest rate, prepayment and other pertinent market factors. Actual credit losses on retained interests have not been significant.

(in millions)	Agency Mortgage-Backed	Other Mortgage- and Asset-Backed
Interest rates		
Impact of 50 basis point adverse change	$ (41.7)	$ (154.1)
Impact of 100 basis point adverse change	(87.4)	(344.8)
Prepayment speeds		
Impact of 10% adverse change	(8.0)	(56.7)

Impact of 20% adverse change	(14.8)	(107.9)
Credit losses		
Impact of 10% adverse change	(5.6)	(134.3)
Impact of 20% adverse change	(11.1)	(257.6)

The above table should be viewed with caution since the changes in a single variable generally cannot occur without changes in other variables or conditions that may counteract or amplify the effect of the changes outlined in the table. Changes in fair value based on adverse variations in assumptions generally cannot be extrapolated because the relationship of the change in assumptions to the change in fair value is not usually linear. In addition, the table does not consider the change in fair value of hedging positions, which would generally offset the changes detailed in the table, nor do they consider any corrective action that the Company may take in response to changes in these conditions. The impact of hedges is not presented because hedging positions are established on a portfolio level and allocating the impact would not be practicable.

Mortgage Servicing Rights

In the normal course of business, the Company originates and purchases conforming and non-conforming, conventional fixed-rate and adjustable-rate residential mortgage loans and sells such loans to investors. In connection with these activities, the Company may retain MSRs that entitle the Company to a future stream of cash flows based on the contractual servicing fee. In addition, the Company may purchase and sell MSRs.

As of December 1, 2006, the Company adopted SFAS No. 156 and elected to carry its MSRs at fair value, with changes in fair value reported in earnings. Prior to December 1, 2006, the Company reported the MSRs on a lower of cost or market basis. The impact of adopting SFAS No. 156 resulted in an after tax increase to opening retained earnings of $1.9 million.

The determination of fair value of the Company's MSRs required management judgment because they are not actively traded. The determination of fair value for MSRs requires valuation processes which combine the use of discounted cash flow models and extensive analysis of current market data to arrive at an estimate of fair value. The cash flow and prepayment assumptions used in the Company's discounted cash flow model are based on empirical data drawn from the historical performance of our MSRs, which we believe are consistent with assumptions used by market participants valuing similar MSRs. The key assumptions used in the valuation of MSRs include mortgage prepayment speeds and the discount rates. These variables can, and generally will, change from quarter to quarter as market conditions and projected interest rates change.

20

At February 28, 2007, the key economic assumptions and the sensitivity of the current fair value of MSRs to immediate changes in those assumptions were as follows:

(in millions)	February 28, 2007
Fair Value of MSRs	$ 580.0

Weighted average constant prepayment rate (in CPR)	35.6%
Impact on fair value of:	
5 CPR adverse change	$ (50.8)
10 CPR adverse change	(87.5)
Weighted average discount rate	13.3%
Impact on fair value of:	
5% adverse change	$ (45.6)
10% adverse change	(82.2)

The above table should be viewed with caution since the changes in a single variable generally cannot occur without changes in other variables or conditions that may counteract or amplify the effect of the changes outlined in the table. Changes in fair value based on adverse variations in assumptions generally cannot be extrapolated because the relationship of the change in assumptions to the change in fair value is not usually linear. In addition, the table does not consider the change in fair value of hedging positions, which would generally offset the changes detailed in the table, nor do they consider any corrective action that the Company may take in response to changes in these conditions. The impact of hedges is not presented because hedging positions are established on a portfolio level and allocating the impact would not be practicable.

MSRs are included in "Other assets" on the Condensed Consolidated Statements of Financial Condition. The Company's MSRs activities for the three months ended February 28, 2007 was as follows:

(in millions)	Three Months Ended February 28, 2007
Balance, beginning of period	$ 502.0
Additions	111.7
Sales	-
Changes in fair value:	
Resulting from changes in valuation inputs/assumptions	2.2
Changes due to adoption of SFAS 156	2.9
Paydowns	(38.8)
Balance, end of period	$ 580.0

5. VARIABLE INTEREST ENTITIES AND MORTGAGE LOAN SPECIAL PURPOSE ENTITIES

The Company regularly creates or transacts with entities that may be variable interest entities (VIEs). These entities are an essential part of its securitization, asset management and structured finance businesses. In addition, the Company purchases and sells financial instruments that may be variable interests. The Company follows the guidance in FIN No. 46(R) and consolidates those VIEs in which the Company is the primary beneficiary.

The Company may perform various functions, including acting as the seller, servicer, investor, structurer or underwriter in securitization transactions. These transactions typically involve entities that are considered to be QSPEs as defined in SFAS No. 140. QSPEs are exempt from the requirements of FIN No. 46 (R). For securitization vehicles that do not qualify as QSPEs, the holders of the beneficial interests have no recourse to the Company, only to the assets held by the related VIE. In certain of these VIEs, the Company could be determined to be the primary beneficiary through its ownership of certain beneficial interests, and would, therefore, be required to consolidate the assets and liabilities of the VIE.

The Company has a limited number of mortgage securitizations that did not meet the criteria for sale treatment under SFAS No. 140, including transactions where the retained call option did not meet the definition of a clean up call under SFAS No. 140. As such, the Company continues to carry the assets and liabilities from these transactions on its Consolidated Statement of Financial Condition.

The Company also acts as portfolio manager and/or underwriter in several collateralized debt obligation transactions. In these transactions, the Company establishes a trust that purchases a portfolio of assets and issues trust certificates that represent interests in the portfolio of assets. In addition, the Company may receive variable compensation for managing the portfolio and may also retain certain trust certificates. In certain of these transactions, these interests result in the Company becoming the primary beneficiary of these entities. The holders of the trust certificates have recourse only to the underlying assets of the trusts and not to other assets of the Company.

The Company establishes and operates funds for the benefit of its employees. These funds are considered to be VIEs of which the Company is the primary beneficiary.

Additionally, the Company invests in certain distressed debt instruments of which the issuers are VIEs. The Company has determined that it is the primary beneficiary of the VIEs.

The Company has made investments in entities that own power plants. These entities are VIEs of which the Company is the primary beneficiary.

The following table sets forth the Company's total assets and maximum exposure to loss associated with its significant variable interests in consolidated VIEs and securitizations that did not qualify for sale treatment. This information is presented based on principal business activity, as reflected in the first column.

	As of February 28, 2007		As of November 30, 2006	
(in millions)	VIE Assets	Maximum Exposure to Loss (1)	VIE Assets	Maximum Exposure to Loss (1)

Mortgage Securitizations	$ 39,314.5	$ 1,136.3	$ 28,984.3	$ 762.0
Collateralized Debt Obligations	1,281.5	37.5	685.0	47.9
Employee Funds (2)	709.9	483.4	575.1	355.0
Distressed Debt	57.4	57.2	58.9	58.8
Energy Investments	119.3	119.3	-	-
Total	$ 41,482.6	$ 1,833.7	$ 30,303.3	$ 1,223.7

(1) Represents the fair value of the Company's interest in these entities and is reflected on the Condensed Consolidated Statements of Financial Condition.

(2) Maximum exposure to loss includes loans the Company has made to employees who participate in the funds, for which the Company is in a second loss position.

Note: Certain prior period amounts have been reclassified to conform to the current period's presentation.

The Company also owns significant variable interests in several VIEs related to collateralized debt obligations for which the Company is not the primary beneficiary and therefore does not consolidate these entities. In aggregate, these VIEs had assets approximating $12.5 billion and $14.8 billion at February 28, 2007 and November 30, 2006, respectively. At February 28, 2007 and November 30, 2006, the Company's maximum exposure to loss from these entities approximated $136.7 million and $163.2 million, respectively, which represents the fair value of its interests

and is reflected in the Condensed Consolidated Statements of Financial Condition.

The Company purchases and sells interests in entities that may be deemed to be VIEs in its market-making capacity in the ordinary course of business. As a result of these activities, it is reasonably possible that such entities may be consolidated or deconsolidated at various points in time. Therefore, the Company's variable interests included above may not be held by the Company in future periods.

6. COLLATERALIZED FINANCING ARRANGEMENTS

The Company enters into secured borrowing and lending agreements to obtain collateral necessary to effect settlements, finance inventory positions, meet customer needs or re-lend as part of its dealer operations.

The Company receives collateral under reverse repurchase agreements, securities borrowing transactions, derivative transactions, customer margin loans and other secured money-lending activities. In many instances, the Company is also permitted by contract or custom to rehypothecate securities received as collateral. These securities may be used to secure repurchase agreements, enter into securities lending or derivative transactions or cover short positions.

At February 28, 2007 and November 30, 2006, the fair value of securities received as collateral by the Company that can be repledged, delivered or otherwise used was approximately $291.84 billion and $286.06 billion, respectively. Of these securities received as collateral, those with a fair value of approximately $199.97 billion and $189.54 billion were delivered, repledged or otherwise used at February 28, 2007 and November 30, 2006, respectively.

The Company also pledges financial instruments owned to collateralize certain financing arrangements and permits the counterparty to pledge or rehypothecate the securities. These securities are recorded as "Financial instruments owned and pledged as collateral, at fair value" in the Condensed Consolidated Statements of Financial Condition. The carrying value of securities and other inventory positions owned that have been pledged or otherwise encumbered to counterparties where those counterparties do not have the right to sell or repledge was approximately $54.57 billion and $41.58 billion at February 28, 2007 and November 30, 2006, respectively.

7. LONG-TERM BORROWINGS

The Company's long-term borrowings (which have original maturities of at least 12 months) at February 28, 2007 and November 30, 2006 consisted of the following:

(in thousands)	February 28, 2007	November 30, 2006
Fixed rate notes due 2007 to 2037	$22,766,235	$22,516,745
Floating rate notes due 2007 to 2046	26,965,733	23,227,794
Index/equity/credit-linked notes	8,762,505	8,825,377
Total long-term borrowings	$58,494,473	$54,569,916

The Company's long-term borrowings include fair value adjustments in accordance with SFAS No. 133 as well as hybrid financial instruments accounted for at fair value as elected under SFAS No. 155. During the three months ended February 28, 2007, the Company issued and retired/repurchased $8.08 billion and $3.55 billion of long-term borrowings, respectively. The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 4.4 years at February 28, 2007.

8. EARNINGS PER SHARE

Basic EPS is computed by dividing net income applicable to common shares, adjusted for costs related to vested shares under the CAP Plan, as well as the effect of the redemption of preferred stock, by the weighted average number of common shares outstanding. Common shares outstanding includes vested units issued under certain stock

compensation plans, which will be distributed as shares of common stock. Diluted EPS includes the determinants of basic EPS and, in addition, gives effect to dilutive potential common shares related to stock compensation plans.

The computations of basic and diluted EPS are set forth below:

(in thousands, except per share amounts)	Three Months Ended February 28, 2007	Three Months Ended February 28, 2006
Net income	$ 553,741	$ 514,156
Preferred stock dividends	(5,257)	(5,414)
Redemption of preferred stock	-	27
Income adjustment (net of tax) applicable to deferred compensation arrangements-vested shares	14,051	11,777
Net earnings used for basic EPS	562,535	520,546
Income adjustment (net of tax) applicable to deferred compensation arrangements-nonvested shares	9,654	8,786
Net earnings used for diluted EPS	$ 572,189	$ 529,332
Total basic weighted average common shares outstanding (1)	133,095	132,739
Effect of dilutive securities:		
Employee stock options	6,536	5,288
CAP and restricted units	10,092	11,390
Dilutive potential common shares	16,628	16,678
Weighted average number of common shares outstanding and dilutive potential common shares	149,723	149,417
Basic EPS	$ 4.23	$ 3.92
Diluted EPS	$ 3.82	$ 3.54

(1) Includes 13,808,471 and 14,684,386 vested units for the three months ended February 28, 2007 and 2006, respectively, issued under stock compensation plans which will be distributed as shares of common stock.

9. REGULATORY REQUIREMENTS

The Company is regulated by the SEC as a consolidated supervised entity ("CSE"). As a CSE, the Company is subject to group-wide supervision and examination by the SEC and is required to compute allowable capital and allowances for market, credit and operational risk on a consolidated basis. As of February 28, 2007, the Company was in compliance with the CSE capital requirements.

Bear Stearns and BSSC are registered broker-dealers and futures commission merchants and, accordingly, are subject to Rule 15c3-1 under the Securities Exchange Act of 1934 ("Net Capital Rule") and Rule 1.17 under the Commodity Futures Trading Commission. Bear Stearns uses Appendix E of the Net Capital Rule which establishes alternative net capital requirements for broker-dealers that are part of consolidated supervised entities. Appendix E allows Bear Stearns to calculate net capital charges for market risk and derivatives-related credit risk based on mathematical models provided that Bear Stearns holds tentative net capital in excess of $1 billion and net capital in excess of $500 million. At February 28, 2007, Bear Stearns' net capital of $3.65 billion exceeded the minimum requirement by $3.10 billion. Bear Stearns' net capital computation, as defined, includes $561.7 million, which is net capital of BSSC in excess of 5.5% of aggregate debit items arising from customer transactions.

BSIL and Bear Stearns International Trading Limited ("BSIT"), London-based broker-dealer subsidiaries, are subject to the regulatory capital requirements of the United Kingdom's Financial Services Authority.

BSB, an Ireland-based bank principally involved in the trading and sales of fixed income products, is registered in

Ireland and is subject to the regulatory capital requirements of the Financial Regulator.

Custodial Trust Company ("CTC"), a Federal Deposit Insurance Corporation ("FDIC") insured New Jersey state chartered bank, offers a range of trust, lending and securities-clearing services. CTC provides the Company with banking powers, including access to the securities and funds-wire services of the Federal Reserve System. CTC is subject to the regulatory capital requirements of the FDIC.

At February 28, 2007, Bear Stearns, BSSC, BSIL, BSIT, BSB and CTC were in compliance with their respective regulatory capital requirements. Certain other subsidiaries are subject to various securities regulations and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. At February 28, 2007, these other subsidiaries were in compliance with their applicable local capital adequacy requirements.

10. COMMITMENTS AND CONTINGENCIES

In the ordinary course of business, the Company has commitments in connection with various activities, the most significant of which are as follows:

Leases

The Company occupies office space under leases that expire at various dates through 2024. At February 28, 2007, future minimum aggregate annual rentals payable under non-cancelable leases (net of subleases), including 383 Madison Avenue in New York City, for fiscal years 2007 through 2011 and the aggregate amount thereafter, are as follows:

(in thousands)

FISCAL YEAR	
2007 (remaining)	$ 78,462
2008	108,298
2009	102,553
2010	104,440
2011	104,966
Thereafter	600,157

Total	$1,098,876

Lending - Related Commitments

In connection with certain of the Company's business activities, the Company provides financing or financing commitments to investment-grade and non-investment-grade companies in the form of senior and subordinated debt, including bridge financing. Commitments have varying maturity dates and are generally contingent on the accuracy and validity of certain representations, warranties and contractual conditions applicable to the borrower. Lending-related commitments to investment-grade borrowers aggregated approximately $3.23 billion and $3.83 billion at February 28, 2007 and November 30, 2006, respectively. Of this amount, approximately $764.5 million and $697.8 million was hedged at February 28, 2007 and November 30, 2006, respectively. Lending-related commitments to non-investment-grade borrowers approximated $2.14 billion and $2.04 billion at February 28, 2007 and November 30, 2006, respectively. Of this amount, approximately $102.8 million and $88.8 million was hedged at February 28, 2007 and November 30, 2006, respectively.

The Company also had contingent commitments to investment-grade and non-investment-grade companies of approximately $6.47 billion and $17.48 billion as of February 28, 2007 and November 30, 2006, respectively. Generally, these commitments are provided in connection with leveraged acquisitions. These commitments are not indicative of the Company's actual risk because the borrower may never draw upon the commitment. In fact, the

borrower may not be successful in the acquisition, the borrower may access the capital markets instead of drawing on the commitment, or the Company's portion of the commitment may be reduced through the syndication process. Additionally, the borrower's ability to draw may be subject to there being no material adverse change in either market conditions or the borrower's financial condition, among other factors. These commitments generally contain certain flexible pricing features to adjust for changing market conditions prior to closing.

Private Equity-Related Investments and Partnerships

In connection with the Company's merchant banking activities, the Company has commitments to invest in merchant banking and private equity-related investment funds as well as commitments to invest directly in private equity-related investments. At February 28, 2007 and November 30, 2006, such commitments aggregated $1.44 billion and $788.3 million, respectively. These commitments will be funded, if called, through the end of the respective investment periods, with the longest of such periods ending in 2017.

Underwriting

In connection with the Company's mortgage-backed securitizations and fixed income underwriting, the Company had commitments to purchase new issues of securities aggregating $531.3 million and $205.0 million, respectively, at February 28, 2007 and November 30, 2006.

Commercial and Residential Loans

The Company participates in the origination, acquisition, securitization, servicing, financing and disposition of commercial and residential loans. At February 28, 2007 and November 30, 2006, the Company had entered into commitments to purchase or finance mortgage loans of $5.63 billion and $4.23 billion, respectively.

Letters of Credit

At February 28, 2007 and November 30, 2006, the Company was contingently liable for unsecured letters of credit of approximately $2.87 billion and $3.30 billion, respectively, and secured (by financial instruments) letters of credit of $1.08 billion and $1.25 million, respectively. These letters of credit are primarily used to provide collateral for securities borrowed and to satisfy margin requirements at fixed income and commodity exchanges.

Other

The Company had commitments to purchase Chapter 13 and other credit card receivables of $195.7 million and $95.7 million, respectively, at February 28, 2007 and November 30, 2006.

With respect to certain of the commitments outlined above, the Company utilizes various hedging strategies to actively manage its market, credit and liquidity exposures. Additionally, since these commitments may expire unused, the total commitment amount may not necessarily reflect the actual future cash funding requirements.

Litigation

The Company is the sole defendant in an action commenced in the United States Bankruptcy Court for the Southern District of New York by the Chapter 11 Trustee for Manhattan Investment Fund Ltd. As previously reported in the Company's Form 10-K for fiscal year ended November 30, 2006, the Bankruptcy Court granted the Trustee's motion for summary judgment on the fraudulent transfer claims against the Company. The Company has appealed the Bankruptcy Court's decision to the United States District for the Southern District of New York.

In the normal course of business, the Company has been named as a defendant in various legal actions, including

arbitrations, class actions and other litigation. Certain of the legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. The Company is also involved in other reviews, investigations and proceedings by governmental and self-regulatory agencies regarding the Company's business, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

Because litigation is inherently unpredictable, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief might be. Consequently, the Company cannot estimate losses or ranges of losses for matters where there is only a reasonable possibility that a loss may have been incurred. Although the ultimate outcome of these matters cannot be ascertained at this time, it is the opinion of management, after consultation with counsel, that the resolution of the foregoing matters will not have a material adverse effect on the financial condition of the Company, taken as a whole; such resolution may, however, have a material effect on the operating results in any future period, depending on the level of income for such period.

The Company has provided reserves for such matters in accordance with SFAS No. 5, "Accounting for Contingencies." The ultimate resolution may differ materially from the amounts reserved.

Tax

The Company is under continuous examination by various tax authorities in jurisdictions in which the Company has significant business operations. The Company regularly evaluates the likelihood of additional assessments in each of the tax jurisdictions resulting from these examinations. Tax reserves have been established, which the Company believes to be adequate in relation to the potential for additional assessments. Once established, reserves are adjusted as information becomes available or when an event requiring a change to the reserve occurs.

11. GUARANTEES

In the ordinary course of business, the Company issues various guarantees to counterparties in connection with certain derivative, leasing, securitization and other transactions. FIN No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," requires the Company to recognize a liability at the inception of certain guarantees and to disclose information about its obligations under certain guarantee arrangements.

The guarantees covered by FIN No. 45 include contracts that contingently require the guarantor to make payments to the guaranteed party based on changes related to an asset, a liability or an equity security of the guaranteed party, contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement and indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes to an asset, liability or equity security of the guaranteed party. In addition, FIN No. 45 covers certain indemnification agreements that contingently require the guarantor to make payments to the indemnified party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.

The following table sets forth the maximum payout/notional amounts associated with the Company's guarantees as of February 28, 2007:

	Amount of Guarantee Expiration Per Period				
(in millions)	Less Than One Year	One to Three Years	Three to Five Years	Greater than Five Years	Total

Certain derivative contracts (notional)(1)	$ 213,947	$ 340,929	$ 539,086	$ 489,176	$1,583,138
Municipal securities	2,651	653	--	--	3,304
Residual value guarantee	--	--	570	--	570

(1) The carrying value of these derivatives approximated $2.9 billion as of February 28, 2007.

Derivative Contracts

The Company's dealer activities cause it to make markets and trade a variety of derivative instruments. Certain derivative contracts that the Company has entered into meet the accounting definition of a guarantee under FIN No. 45. Derivatives that meet the FIN No. 45 definition of guarantees include credit default swaps (whereby a default or significant change in the credit quality of the underlying financial instrument may obligate the Company to make a payment), put options, as well as floors, caps and collars. Since the Company does not track the counterparties' purpose for entering into a derivative contract, it has disclosed derivative contracts that are likely to be used to protect against a change in an underlying financial instrument, regardless of their actual use.

On certain of these contracts, such as written interest rate caps and foreign currency options, the maximum payout cannot be quantified since the increase in interest rates and foreign exchange rates is not contractually limited by the terms of the contracts. As such, the Company has disclosed notional amounts as a measure of the extent of its involvement in these classes of derivatives rather than maximum payout. Notional amounts do not represent the maximum payout and generally overstate the Company's exposure to these contracts. These derivatives contracts are recorded at fair value, which approximated $2.9 billion at February 28, 2007.

In connection with these activities, the Company attempts to mitigate its exposure to market risk by entering into a variety of offsetting derivatives contracts and security positions.

Municipal Securities

In 1997, the Company established a program whereby it created a series of municipal securities trusts in which it has retained interests. These trusts purchase fixed-rate, long-term, highly rated, insured or escrowed municipal bonds financed by the issuance of trust certificates. Certain of the trust certificates entitle the holder to receive future payments of principal and variable interest and to tender such certificates at the option of the holder on a periodic basis. The Company acts as placement agent and as liquidity provider. The purpose of the program is to allow the Company's clients to purchase synthetic short-term, floating-rate municipal debt that does not otherwise exist in the marketplace. In the Company's capacity as liquidity provider to the trusts, the maximum exposure to loss at February 28, 2007 was approximately $3.30 billion, which represents the outstanding amount of all trust certificates. This exposure to loss is mitigated by the underlying municipal bonds held by trusts. The underlying municipal bonds in the trusts are either AAA or AA rated, insured or escrowed to maturity. Such bonds had a market value, net of related hedges, approximating $3.39 billion at February 28, 2007.

Residual Value Guarantee

The Company has entered into an operating lease arrangement for its world headquarters at 383 Madison Avenue in New York City (the "Synthetic Lease"). Under the terms of the Synthetic Lease, the Company is obligated to make monthly payments based on the lessor's underlying interest costs. The Synthetic Lease expires on August 12, 2011 unless both parties agree to a renewal prior to expiration. At the expiration date of the Synthetic Lease, the Company

has the right to purchase the building for the amount of the then outstanding indebtedness of the lessor or to arrange for the sale of the property with the proceeds of the sale to be used to satisfy the lessor's debt obligation. If the sale of the property does not generate sufficient proceeds to satisfy the lessor's debt obligation, the Company is required to fund the shortfall up to a maximum residual value guarantee. As of February 28, 2007, there was no expected shortfall and the maximum residual value guarantee approximated $570 million.

Indemnifications

The Company provides representations and warranties to counterparties in connection with a variety of commercial transactions, including certain asset sales and securitizations and occasionally indemnifies them against potential losses caused by the breach of those representations and warranties. To mitigate these risks with respect to assets being securitized that have been originated by third parties, the Company seeks to obtain appropriate representations and warranties from such third-party originators upon acquisition of such assets. The Company generally performs due diligence on assets purchased and maintains underwriting standards for assets originated. The Company may also provide indemnifications to some counterparties to protect them in the event additional taxes are owed or payments are withheld, due either to a change in or adverse application of certain tax laws. These indemnifications generally are standard contractual terms and are entered into in the normal course of business. Generally, there are no stated or notional amounts included in these indemnifications.

Maximum payout information under these indemnifications is not readily available because of the number, size and lives of these transactions. In implementing this accounting interpretation, the Company reviewed its experience with the indemnifications on these structures. Based on such experience, it is unlikely that these arrangements will have a material impact on the Condensed Consolidated Financial Statements of the Company.

Other Guarantees

The Company is a member of numerous exchanges and clearinghouses. Under the membership agreements, members are generally required to guarantee the performance of other members. Additionally, if a member becomes unable to satisfy its obligations to the clearinghouse, other members would be required to meet these shortfalls. To mitigate these performance risks, the exchanges and clearinghouses often require members to post collateral. The Company's maximum potential liability under these arrangements cannot be quantified. However, the potential for the Company to be required to make payments under these arrangements is remote. Accordingly, no contingent liability is recorded in the consolidated financial statements for these arrangements.

12. SEGMENT DATA

The Company operates in three principal segments -- Capital Markets, Global Clearing Services and Wealth Management. These segments offer different products and services and are managed separately as different levels and types of expertise are required to effectively manage the segments' transactions.

The Capital Markets segment comprises the institutional equities, fixed income and investment banking areas. The Capital Markets segment operates as a single integrated unit that provides the sales, trading and origination effort for various fixed income, equity and advisory products and services. Each of the three businesses work in tandem to deliver these services to institutional and corporate clients.

Institutional equities consists of sales, trading and research, in areas such as domestic and international equities, block trading, over-the-counter equities, equity derivatives, energy and commodity activities, risk and convertible arbitrage and, through a majority-owned joint venture, specialist activities on the NYSE, AMEX and ISE. Fixed income includes sales, trading, origination and research provided to institutional clients across a variety of products such as mortgage- and asset-backed securities, corporate and government bonds, municipal bonds, high yield products, including bank and bridge loans, foreign exchange and interest rate and credit derivatives. Investment

29

banking provides services in capital raising, strategic advice, mergers and acquisitions and merchant banking. Capital raising encompasses the Company's underwriting of equity, investment grade, municipal and high yield debt products.

The Global Clearing Services segment provides execution, clearing, margin lending and securities borrowing to facilitate customer short sales to clearing clients worldwide. Prime brokerage clients include hedge funds and clients of money managers, short sellers and other professional investors. Fully disclosed clients engage in either the retail or institutional brokerage business.

The Wealth Management segment is composed of the PCS and asset management areas. PCS provides high-net-worth individuals with an institutional level of investment service, including access to the Company's resources and professionals. Asset management manages equity, fixed income and alternative assets for leading corporate pension plans, public systems, endowments, foundations, multi-employer plans, insurance companies,
co