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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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*(Mark One)*

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2007

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 1-11921

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**E\*TRADE Financial Corporation**

(Exact name of Registrant as Specified in its Charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**94-2844166**  
(I.R.S. Employer  
Identification Number)

**135 East 57<sup>th</sup> Street, New York, New York 10022**  
(Address of Principal Executive Offices and Zip Code)

**(646) 521-4300**  
(Registrant's Telephone Number, including Area Code)

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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  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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

As of May 4, 2007, there were 426,865,051 shares of common stock outstanding.

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**E\*TRADE FINANCIAL CORPORATION**  
**FORM 10-Q QUARTERLY REPORT**  
**For the Quarter Ended March 31, 2007**  
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*Unless otherwise indicated, references to "the Company," "We," "Us," "Our" and "E\*TRADE" mean E\*TRADE Financial Corporation or its subsidiaries.*

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**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

This information is set forth immediately following Item 3, “Quantitative and Qualitative Disclosures about Market Risk.”

**ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with the consolidated financial statements and the related notes that appear elsewhere in this document.*

**FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements involving risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. These statements may be identified by the use of words such as “expect,” “may,” “anticipate,” “intend,” “plan” and similar expressions. Our actual results could differ materially from those discussed in these forward-looking statements, and we caution that we do not undertake to update these statements. Factors that could contribute to our actual results differing from any forward-looking statements include those discussed under “Risk Factors,” “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this report. The cautionary statements made in this report should be read as being applicable to all forward-looking statements wherever they appear in this report. Important factors that may cause actual results to differ materially from any forward-looking statements are set forth in our 2006 Form 10-K filed with the Securities and Exchange Commission (“SEC”) under the heading “Risk Factors.”

We further caution that there may be risks associated with owning our securities other than those discussed in such filings.

**GLOSSARY OF TERMS**

In analyzing and discussing our business, we utilize certain metrics, ratios and other terms that are defined in the “Glossary of Terms,” which is located at the end of Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

**OVERVIEW**

*Strategy*

Our strategy centers on strengthening and growing our retail business and leveraging that growth in our institutional business. We strive to further develop our retail business by acquiring, retaining and expanding our relationships with global retail customers. We offer our retail and institutional customers a suite of investing, trading, banking and lending products. We plan to grow these relationships organically by using technology to deliver an attractive combination of product, service and price to the value-driven mass affluent customer. We also intend to grow, where appropriate, through targeted acquisitions which leverage our existing business platform and through further expansion into certain international markets.

*Key Factors Affecting Financial Performance*

Our financial performance is affected by a number of factors outside of our control, including:

- customer demand for financial products and services;
- competitors’ pricing on financial products and services;
- interest rates and the shape of the interest rate yield curve; and
- the performance, volume and volatility of the equity and capital markets.

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In addition to the items noted above, our success in the future will depend upon, among other things:

- continuing our success in the acquisition, growth and retention of customers;
- deepening customer acceptance of our investing, trading, banking and lending products;
- disciplined expense control and improved operational efficiency;
- maintaining strong overall asset quality; and
- prudent risk and capital management.

Management monitors a number of metrics in evaluating the Company's performance. The most significant of these are shown in the table and discussed in the text below:

|  | At or For the<br>Three Months Ended<br>March 31, |          | Variance      |
|--|--|----------|---------------|
|  | 2007   | 2006     | 2007 vs. 2006 |
| <b>Customer Activity Metrics:</b>                        |  |          |               |
| Retail client assets (dollars in billions)               | \$ 200.5   | \$ 192.0 | 4 %           |
| Customer cash and deposits (dollars in billions)         | \$ 36.0  | \$ 29.8  | 21 %          |
| U.S. daily average revenue trades                        | 141,238  | 159,199  | (11)%         |
| International daily average revenue trades               | 28,798   | 21,960   | 31 %          |
| Total daily average revenue trades                       | 170,036  | 181,159  | (6)%          |
| Average commission per trade                             | \$ 11.89   | \$ 12.10 | (2)%          |
| <b>Company Financial Metrics:</b>                        |  |          |               |
| Net revenue growth <sup>(1)</sup>                        | 8%   | 43%      | (35)%         |
| Enterprise net interest spread (basis points)            | 274  | 286      | (4)%          |
| Enterprise interest-earning assets (average in billions) | \$ 52.9  | \$ 41.3  | 28 %          |
| Operating margin (%)                                     | 42%  | 41%      | 1 %           |
| Compensation and benefits as a % of revenue              | 19%  | 19%      | (0)%          |

<sup>(1)</sup> Revenue growth is the difference between the current and prior comparable period total net revenue divided by the prior comparable period total net revenue.

### Customer Activity Metrics

- Retail client assets are an indicator of the value of our relationship with the customer. An increase in retail client assets generally indicates that the use of our products and services by existing and new customers is expanding. Changes in this metric are also driven by changes in the valuations of our customers' underlying securities.
- Customer cash and deposits are an indicator of a deepening engagement with our customers and are key drivers of net operating interest income.
- Daily average revenue trades ("DARTs") are the predominant driver of commission revenue from our retail customers.
- Average commission per trade is impacted by the mix between our retail domestic and international businesses and the mix between active traders, mass affluent and main street customers. This metric is an indicator of changes in our customer mix, product mix and/or product pricing.

### Company Financial Metrics

- Net revenue growth is an indicator of our overall financial well-being and our ability to execute on our strategy. When coupled with operating margin, the two provide information about the general success of our business.
- Enterprise net interest spread is a broad indicator of our ability to generate net operating interest income.

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- Enterprise interest-earning assets, in conjunction with our enterprise net interest spread, are indicators of our ability to generate net operating interest income.
- Operating margin is an indicator of the profitability of our operations.
- Compensation and benefits as a percentage of revenue is an indicator of our productivity. This ratio coupled with operating margin is an indicator of our efficiency.

### ***Significant Events in the First Quarter of 2007***

#### *Launch of Global Trading Platform Pilot Program*

We launched our Global Trading Platform pilot program, which provides the ability to buy, sell and hold foreign equities in local currencies to investors who seek liquidity and diversity in their portfolios. Under the pilot program, certain of our U.S. customers now have access to foreign stocks and currencies in six major international markets: Canada, France, Germany, Hong Kong, Japan and the United Kingdom.

#### *Introduction of the Max-Rate Checking Account*

E\*TRADE Bank introduced a Max-Rate Checking Account which features an annual percentage yield up to 3.25%, unlimited check writing and free online bill pay, among other benefits.

### ***Summary Financial Results***

*Income Statement Highlights for the Three Months Ended March 31, 2007 (dollars in millions, except per share amounts)*

|   | Three Months Ended |          | Variance<br>2007 vs. 2006 |
|---|--------------------|----------|---------------------------|
|   | March 31,          |          |                           |
|   | 2007               | 2006     |                           |
| Total net revenue   | \$ 645.0           | \$ 598.3 | 8%                        |
| Net operating interest income after provision for loan losses | \$ 369.4           | \$ 314.6 | 17%                       |
| Operating margin  | \$ 270.6           | \$ 243.8 | 11%                       |
| Net income  | \$ 169.4           | \$ 142.5 | 19%                       |
| Diluted net earnings per share                                | \$ 0.39            | \$ 0.33  | 18%                       |
| Operating margin (%)  | 42%                | 41%      | 1%                        |

During the first quarter of 2007, despite volatility in the global equity markets and increased pressure on the domestic real estate market, we continued to strengthen our operating and financial performance. Total net revenue and net income increased 8% and 19%, respectively, when compared to the corresponding period in the prior year. We believe the investments we have made in marketing, operations and service are driving organic growth in customer cash and deposits and margin receivables, which are the primary drivers of our increase in net income. We were able to achieve this growth while increasing our operating margin to 42% in the first quarter of 2007 from 41% when compared to the same period in the prior year. We believe this growth in operating margin reflects increasing efficiencies in our operations and control over our operating expenses.

Net operating interest income after provision for loan losses increased 17% to \$369.4 million for the three months ended March 31, 2007, compared with the same period in 2006. Net operating interest income benefited from increases in customer cash and deposits, which increased \$6.2 billion compared to the same period in 2006. The increase in customer cash and deposits resulted from organic growth, primarily in our new Complete Savings Account, which was launched at the end of 2006. This new product has driven measurable growth in cash from new and existing customers. In addition, customers who utilized this new product tended to engage more broadly with our other products and services.

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### **Balance Sheet Highlights (dollars in billions)**

|   | <u>March 31,</u><br><u>2007</u> | <u>December 31,</u><br><u>2006</u> | <u>Variance</u><br><u>2007 vs. 2006</u> |
|---|---------------------------------|------------------------------------|---|
| Total assets  | \$ 60.1                         | \$ 53.7                            | 12%                                     |
| Total average enterprise interest-earning assets <sup>(1) (2)</sup>   | \$ 52.9                         | \$ 49.6                            | 7%                                      |
| Average loans, net and margin receivables as a percentage of enterprise interest-earning assets <sup>(1) (2)</sup>          | 66%                             | 65%                                | 1%                                      |
| Average retail deposits and customer payables as a percentage of enterprise interest-bearing liabilities <sup>(1) (2)</sup> | 62%                             | 62%                                | 0%                                      |

(1) The table data on average enterprise interest-earning assets, loans, net and margin receivables, retail deposits and customer payables has been prepared on the basis required by the SEC's Industry Guide 3, "Statistical Disclosure by Bank Holding Companies".

(2) Percentages calculated reflect data for the three months ended March 31, 2007 and December 31, 2006.

The increase in total assets was attributable primarily to increases of \$3.3 billion in loans receivable, net and \$2.5 billion in available-for-sale mortgage-backed and investment securities. The increase in loans receivable, net was due principally to growth in our real estate loan portfolio. We continue to focus our efforts on growing our residential mortgage loan portfolios, primarily one- to four-family loans, and allowing our consumer loan portfolio to decline. Average enterprise interest-earning assets increased by \$11.5 billion in the first three months of 2007 compared to the same period in 2006, which was related primarily to the increase in average loans, net and margin receivables.

Retail deposits and customer payables were \$32.1 billion, up 8% or \$2.4 billion during the first three months of 2007. Retail deposits and customer payables are two of our lowest cost sources of funding and are important contributors to our net operating interest income growth. The increase during the period was due primarily to growth in the Complete Savings Account.

### **EARNINGS OVERVIEW**

Net income increased 19% to \$169.4 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase was a result of strong growth in interest-earning assets, which are funded primarily by retail deposits and customer payables. In addition, we were able to achieve this growth while increasing our operating margin to 42% in the first quarter of 2007 from 41% when compared to the same period in the prior year. We believe this growth in operating margin is reflective of increasing efficiencies in our operations.

We report corporate interest income and corporate interest expense separately from operating interest income and operating interest expense. We believe reporting these two items separately provides a clearer picture of the financial performance of our operations than would a presentation that combined these two items. Our operating interest income and operating interest expense is generated from the operations of the Company and is a broad indicator of our success in our banking, lending and balance sheet management businesses. Our corporate debt, which is the primary source of our corporate interest expense, has been used primarily to finance acquisitions, such as *Harrisdirect* and *BrownCo*, and generally has not been downstreamed to any of our operating subsidiaries.

Similarly, we report gain on sales and impairment of investments separately from gain on sales of loans and securities, net. We believe reporting these two items separately provides a clearer picture of the financial performance of our operations than would a presentation that combined these two items. Gain on sales of loans and securities, net are the result of activities in our operations, namely our lending and balance sheet management businesses. Gain on sales and impairment of investments relates to historical equity investments of the Company at the corporate level and are not related to the ongoing business of our operating subsidiaries.

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The following sections describe in detail the changes in key operating factors and other changes and events that have affected our consolidated net revenue, expense excluding interest, other income (expense) and income tax expense.

### Revenue

The components of net revenue and the resulting variances are as follows (dollars in thousands):

|   | Three Months Ended<br>March 31, |            | Variance<br>2007 vs. 2006 |       |
|---|---------------------------------|------------|---------------------------|-------|
|   | 2007                            | 2006       | Amount                    | %     |
| <b>Revenue:</b>   |                                 |            |                           |       |
| Operating interest income                                     | \$ 829,795                      | \$ 594,294 | \$ 235,501                | 40 %  |
| Operating interest expense                                    | (439,209)                       | (269,505)  | (169,704)                 | 63 %  |
| Net operating interest income                                 | 390,586                         | 324,789    | 65,797                    | 20 %  |
| Provision for loan losses                                     | (21,186)                        | (10,197)   | (10,989)                  | 108 % |
| Net operating interest income after provision for loan losses | 369,400                         | 314,592    | 54,808                    | 17 %  |
| Commission  | 158,993                         | 175,869    | (16,876)                  | (10)% |
| Fees and service charges                                      | 59,498                          | 57,862     | 1,636                     | 3 %   |
| Principal transactions  | 30,082                          | 30,692     | (610)                     | (2)%  |
| Gain on sales of loans and securities, net                    | 17,375                          | 11,628     | 5,747                     | 49 %  |
| Other revenue   | 9,650                           | 7,706      | 1,944                     | 25 %  |
| Total non-interest income                                     | 275,598                         | 283,757    | (8,159)                   | (3)%  |
| Total net revenue   | \$ 644,998                      | \$ 598,349 | \$ 46,649                 | 8 %   |

Net operating interest income after provision for loan losses continues to be our largest source of revenue and now represents 57% of total net revenue for the three months ended March 31, 2007. This reflects our focus on retaining retail customer cash and deposits and retail credit balances. Net operating interest income is earned primarily through holding credit balances, which includes margin, real estate and consumer loans, and by holding customer cash and deposits, which are a low cost source of funding. The table below presents each revenue component as a percentage of total net revenue.

|   | Three Months Ended<br>March 31, |      | Variance<br>2007 vs. 2006 |
|---|---------------------------------|------|---------------------------|
|   | 2007                            | 2006 |                           |
| <b>Revenue:</b>   |                                 |      |                           |
| Net operating interest income after provision for loan losses | 57%                             | 53%  | 4 %                       |
| Commission <sup>(1)</sup>                                     | 25                              | 29   | (4)%                      |
| Fees and service charges                                      | 9                               | 10   | (1)%                      |
| Principal transactions  | 5                               | 5    | 0 %                       |
| Gain on sales of loans and securities, net                    | 3                               | 2    | 1 %                       |
| Other revenue   | 1                               | 1    | 0 %                       |
| Total net revenue   | 100%                            | 100% | —%                        |

<sup>(1)</sup> Retail commission revenue represented 19% and 23% of total net revenue for the three months ended March 31, 2007 and 2006, respectively. Institutional commission revenue represented 6% and 7% of total net revenue for the three months ended March 31, 2007 and 2006, respectively.

### Net Operating Interest Income After Provision for Loan Losses

Net operating interest income after provision for loan losses increased 17% to \$369.4 million for the three months ended March 31, 2007, compared to the same period in 2006. The increase in net operating interest income was due primarily to growth in enterprise interest-earning assets, specifically loans, net. Average loans, net as a percentage of average enterprise interest-earning assets increased 6% to 53% for the three months ended March 31, 2007 compared to the same period in 2006.

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The following table presents enterprise average balance sheet data and enterprise income and expense data for our operations, as well as the related net interest spread, yields and rates and has been prepared on the basis required by the SEC's Industry Guide 3, "Statistical Disclosure by Bank Holding Companies" (dollars in thousands):

|  | Three Months Ended March 31, |                              |                    |                 |                              |                    |
|--|------------------------------|------------------------------|--------------------|-----------------|------------------------------|--------------------|
|  | 2007                         |                              |                    | 2006            |                              |                    |
|  | Average Balance              | Operating Interest Inc./Exp. | Average Yield/Cost | Average Balance | Operating Interest Inc./Exp. | Average Yield/Cost |
| <b>Enterprise interest-earning assets:</b>   |                              |                              |                    |                 |                              |                    |
| Loans, net   | \$ 28,093,409                | \$ 451,399                   | 6.43%              | \$19,571,064    | \$ 281,270                   | 5.75%              |
| Margin receivables   | 6,787,828                    | 123,986                      | 7.41%              | 6,477,585       | 104,904                      | 6.57%              |
| Mortgage-backed and related available-for-sale securities  | 12,040,109                   | 157,967                      | 5.25%              | 10,555,616      | 125,504                      | 4.76%              |
| Available-for-sale investment securities   | 3,901,434                    | 63,496                       | 6.52%              | 2,519,826       | 37,389                       | 5.94%              |
| Trading securities   | 119,779                      | 3,269                        | 10.92%             | 138,660         | 2,648                        | 7.64%              |
| Cash and cash equivalents <sup>(1)</sup>   | 1,358,120                    | 15,930                       | 4.76%              | 1,549,180       | 15,899                       | 4.16%              |
| Stock borrow and other   | 570,805                      | 10,051                       | 7.14%              | 530,629         | 7,730                        | 5.91%              |
| Total enterprise interest-earning assets   | 52,871,484                   | 826,098                      | 6.27%              | 41,342,560      | 575,344                      | 5.56%              |
| Non-operating interest-earning assets <sup>(2)</sup>   | 4,422,167                    |                              |                    | 4,915,704       |                              |                    |
| Total assets   | \$ 57,293,651                |                              |                    | \$46,258,264    |                              |                    |
| <b>Enterprise interest-bearing liabilities:</b>  |                              |                              |                    |                 |                              |                    |
| Retail deposits  | \$ 24,696,611                | 177,329                      | 2.91%              | \$18,120,089    | 90,505                       | 2.03%              |
| Brokered certificates of deposit   | 466,559                      | 5,659                        | 4.92%              | 420,600         | 4,113                        | 3.97%              |
| Customer payables  | 6,380,411                    | 20,479                       | 1.30%              | 6,759,733       | 16,373                       | 0.98%              |
| Repurchase agreements and other borrowings   | 12,137,872                   | 159,031                      | 5.24%              | 9,855,018       | 111,520                      | 4.53%              |
| Federal Home Loan Bank ("FHLB") advances   | 4,996,389                    | 62,852                       | 5.03%              | 3,054,111       | 32,539                       | 4.26%              |
| Stock loan and other   | 1,349,305                    | 12,515                       | 3.76%              | 669,753         | 4,197                        | 2.54%              |
| Total enterprise interest-bearing liabilities  | 50,027,147                   | 437,865                      | 3.53%              | 38,879,304      | 259,247                      | 2.70%              |
| Non-operating interest-bearing liabilities <sup>(3)</sup>  | 3,016,712                    |                              |                    | 3,918,572       |                              |                    |
| Total liabilities  | 53,043,859                   |                              |                    | 42,797,876      |                              |                    |
| Total shareholders' equity   | 4,249,792                    |                              |                    | 3,460,388       |                              |                    |
|  | \$ 57,293,651                |                              |                    | \$46,258,264    |                              |                    |
| <b>Excess of enterprise interest-earning assets over enterprise interest-bearing liabilities/Enterprise net interest income/Spread</b> | \$ 2,844,337                 | \$ 388,233                   | 2.74%              | \$ 2,463,256    | \$ 316,097                   | 2.86%              |
| Enterprise net interest margin (net yield on enterprise interest-earning assets)   |                              |                              | 2.94%              |                 |                              | 3.06%              |
| Ratio of enterprise interest-earning assets to enterprise interest-bearing liabilities   |                              |                              | 105.69%            |                 |                              | 106.34%            |
| Return on average:   |                              |                              |                    |                 |                              |                    |
| Total assets   |                              |                              | 1.18%              |                 |                              | 1.23%              |
| Total shareholders' equity   |                              |                              | 15.95%             |                 |                              | 16.47%             |
| Average equity to average total assets   |                              |                              | 7.42%              |                 |                              | 7.48%              |
| Reconciliation from enterprise net interest income to net operating interest income (dollars in thousands):                            |                              |                              |                    |                 |                              |                    |
|  | Three Months Ended March 31, |                              |                    |                 |                              |                    |
|  | 2007                         |                              | 2006               |                 |                              |                    |
| Enterprise net interest income <sup>(4)</sup>  | \$ 388,233                   | \$ 316,097                   |                    |                 |                              |                    |
| Taxable equivalent interest adjustment   | (7,320)                      | (3,392)                      |                    |                 |                              |                    |
| Stock conduit, net <sup>(5)</sup>  | 9                            | 262                          |                    |                 |                              |                    |
| Customer cash held by third parties <sup>(6)</sup>   | 9,664                        | 11,822                       |                    |                 |                              |                    |
| Net operating interest income  | \$ 390,586                   | \$ 324,789                   |                    |                 |                              |                    |

(1) Includes segregated cash balances.

(2) Non-operating interest-earning assets consist of property and equipment, net, goodwill, other intangibles, net and other assets that do not generate operating interest income. Some of these assets generate corporate interest income.

(3) Non-operating interest-bearing liabilities consist of corporate debt, accounts payable, accrued and other liabilities that do not generate operating interest expense. Some of these liabilities generate corporate interest expense.

(4) Enterprise net interest income is taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties. Management believes this non-GAAP measure is useful to analysts and investors as it is a measure of the net operating interest income generated by our operations.

(5) Net operating interest income earned on average stock conduit assets of \$2.7 million and \$824.0 million for the quarters ended March 31, 2007 and 2006, respectively.

(6) Includes interest earned on average customer assets of \$3.9 billion and \$3.6 billion for the quarters ended March 31, 2007 and 2006, respectively, held by parties outside E\*TRADE Financial, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions.



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Average enterprise interest-earning assets increased 28% to \$52.9 billion for the three months ended March 31, 2007 compared to the same period in 2006. Average loans, net and margin receivables grew 44% to \$28.1 billion and 5% to \$6.8 billion, respectively, for the three months ended March 31, 2007 compared to the same period in 2006. Average loans, net grew as a result of our focus on growing mortgage loan products.

Average enterprise interest-bearing liabilities increased 29% to \$50.0 billion for the three months ended March 31, 2007 compared to the same period in 2006. The increase in average enterprise interest-bearing liabilities was primarily in low-cost customer deposits. Average retail deposits increased 36% to \$24.7 billion for the three months ended March 31, 2007 compared to the same period in 2006. Increases in average retail deposits were driven by growth in the Complete Savings Account.

Enterprise net interest spread decreased by 12 basis points to 2.74% for the three months ended March 31, 2007 compared to the same period in 2006. This minor decrease was primarily the result of the challenging interest rate environment in which the yield curve continues to remain relatively flat to inverted.

### *Provision for Loan Losses*

Provision for loan losses increased 108% to \$21.2 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase in the provision for loan losses was related primarily to the growth in our mortgage loan portfolio and the increase in delinquent loans during the period. While our credit standards have remained strong, we anticipate upward trends in delinquencies and charge-offs compared to 2006 as a result of the continued seasoning of our mortgage loan portfolio and the current instability in the overall consumer credit market. The provision for loan losses is expected to increase in future periods consistent with the seasoning of the portfolio. Further deterioration in the consumer credit market could drive an increase in the provision for loan losses above the amounts recorded during the first quarter of 2007.

### *Commission*

Retail and institutional commission revenue decreased 10% to \$159.0 million for the three months ended March 31, 2007 compared to the same period in 2006. The primary factors that affect our commission revenue are DARTs and average commission per trade, which is impacted by both trade types and the mix between our domestic and international businesses. Each business has a different pricing structure, unique to its customer base and local market practices, and as a result, a change in the relative number of executed trades in these businesses impacts average commission per trade. Each business also has different trade types (e.g. equities, options, fixed income, exchange-traded funds, contract for difference and mutual funds) that can have different commission rates. As a result, changes in the mix of trade types within either of these businesses may impact average commission per trade.

DARTs decreased 6% to 170,036 for the three months ended March 31, 2007 compared to the same period in 2006. Our U.S. DART volume decreased 11% from 2006, driven by changing market conditions and decreased trading activities. Our international DARTs grew by 31% compared to 2006, driven entirely by organic growth. Our international operations continue to be a strong growth contributor within our retail trading business, and we believe that over time they will become a significant component of our entire business. In addition, option-related DARTs further increased as a percentage of our total U.S. DARTs and now represent 14% of U.S. trading volume versus 12% a year ago.

Average commission per trade decreased 2% to \$11.89 for the three months ended March 31, 2007 compared to 2006. The decrease was primarily a function of the mix of customers. Main Street Investors, who generally have a higher commission per trade, traded less during the period which resulted in a heavier weighting of Active Traders, who generally have a lower commission per trade.

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### *Fees and Service Charges*

During the period ended March 31, 2007, the Company re-defined the line item "Service charges and fees" by reclassifying certain fee-like revenue items formerly reported in "Other revenue" into the "Service charges and fees" line item, now called "Fees and service charges." The fee-like revenue streams moved include payment for order flow, foreign currency margin revenue, 12b-1 fees after rebates, fixed income product revenues and management fee revenue.

Fees and service charges increased 3% to \$59.5 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase was due to an increase in our advisor management fees, partially offset by a decrease in account maintenance fees. We expect our account maintenance fee income to continue to decline over time as we have fewer customers who are subject to the fee; however, we expect our advisory management fee income, which is not currently a significant portion of fees and service charges, to increase over time as we focus on growing this product.

### *Principal Transactions*

Principal transactions decreased 2% to \$30.1 million for the three months ended March 31, 2007, compared to the same period in 2006. The decrease in principal transactions resulted from lower trading volumes and market volatility which were compounded by a decrease in the average revenue earned per trade. Our principal transactions revenue is influenced by overall trading volumes, the number of stocks for which we act as a market maker, the trading volumes of those specific stocks and the performance of our proprietary trading activities.

### *Gain on Sales of Loans and Securities, Net*

Gain on sales of loans and securities, net increased 49% to \$17.4 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands):

|  | Three Months Ended<br>March 31, |                 | Variance<br>2007 vs. 2006 |       |
|--|---------------------------------|-----------------|---------------------------|-------|
|  | 2007                            | 2006            | Amount                    | %     |
| Gain on sales of originated loans          | \$ 1,915                        | \$ 3,318        | \$(1,403)                 | (42)% |
| Loss on sales of loans held-for-sale, net  | (1,662)                         | (689)           | (973)                     | 141 % |
| Gain on sales of loans, net                | 253                             | 2,629           | (2,376)                   | (90)% |
| Gain on sales of securities, net           | 17,122                          | 8,999           | 8,123                     | 90 %  |
| Gain on sales of loans and securities, net | <u>\$17,375</u>                 | <u>\$11,628</u> | <u>\$ 5,747</u>           | 49 %  |

The increase in the total gain on sales of loans and securities, net during the three months ended March 31, 2007 was due primarily to an increase in gain on sales of securities, partially offset by the decrease in gain on sales of originated loans compared to the same period in 2006. Retail mortgage loan origination volumes decreased during the comparable periods and we retained a greater number of originated mortgage loans on the balance sheet to drive growth in net operating interest income. The increase in gain on sales of securities, net resulted from higher security sales volumes for the three months ended March 31, 2007 compared to same period in 2006.

### *Other Revenue*

Other revenue increased 25% to \$9.7 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase in other revenue was due to an increase in software consulting fees from our Corporate Services business.

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[Table of Contents](#)**Expense Excluding Interest**

The components of expense excluding interest and the resulting variances are as follows (dollars in thousands):

|  | Three Months Ended |                  | Variance         |            |
|--|--------------------|------------------|------------------|------------|
|  | March 31,          |                  | 2007 vs. 2006    |            |
|  | 2007               | 2006             | Amount           | %          |
| Compensation and benefits                        | \$123,782          | \$115,988        | \$ 7,794         | 7 %        |
| Clearing and servicing                           | 67,252             | 63,288           | 3,964            | 6 %        |
| Advertising and marketing development            | 45,592             | 34,781           | 10,811           | 31 %       |
| Communications                                   | 26,156             | 31,408           | (5,252)          | (17)%      |
| Professional services                            | 24,985             | 27,755           | (2,770)          | (10)%      |
| Depreciation and amortization                    | 19,383             | 18,789           | 594              | 3 %        |
| Occupancy and equipment                          | 23,579             | 20,504           | 3,075            | 15 %       |
| Amortization of other intangibles                | 10,268             | 11,332           | (1,064)          | (9)%       |
| Facility restructuring and other exit activities | 733                | (253)            | 986              | *          |
| Other  | 32,675             | 31,005           | 1,670            | 5 %        |
| Total expense excluding interest                 | <u>\$374,405</u>   | <u>\$354,597</u> | <u>\$ 19,808</u> | <u>6 %</u> |

\* Percentage not meaningful

Expense excluding interest increased 6% to \$374.4 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase in expense excluding interest was driven primarily by an increase in marketing initiatives and increased compensation and benefits expense.

**Compensation and Benefits**

Compensation and benefits increased 7% to \$123.8 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase resulted primarily from increased variable and incentive compensation expense. These increases in compensation are in line with the growth and performance of our business and our focus on enhancing customer service with additional representatives. We believe compensation and benefits as a percentage of revenue is a measure of our efficiency and the most relevant metric to assess this expense. This ratio was 19% for both the three month periods ending March 31, 2007 and 2006.

**Clearing and Servicing**

Clearing and servicing expense increased 6% to \$67.3 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase is due to higher loan balances during the period, which resulted in higher servicing costs.

**Advertising and Market Development**

Advertising and market development expense increased 31% to \$45.6 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase is a result of expanded efforts to promote our products and services to the value-driven mass affluent customer.

**Communications**

Communications expense decreased 17% to \$26.2 million for the three months ended March 31, 2007 compared to the same period in 2006. The decrease is due to higher expenses in 2006 associated with communications to our newly acquired customers from HarrisDirect and BrownCo. In addition, variable expenses such as quote services and trade confirmations decreased with our decrease in trading volume.

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### *Professional Services*

Professional services decreased 10% to \$25.0 million for the three months ended March 31, 2007 compared to the same period in 2006. The decrease is due primarily to higher third party support services in 2006, including technology and transitional service agreements, associated with our integrations of Harrisdirect and BrownCo in 2006.

### *Occupancy and Equipment*

Occupancy and equipment increased 15% to \$23.6 million for the three months ended March 31, 2007 compared to the same period in 2006. The increase is due primarily to new or expanded customer service centers.

### *Other Income (Expense)*

Other income (expense) decreased from an expense of \$22.1 million to an expense of \$8.2 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands):

|  | Three Months Ended |                    | Variance         |          |
|--|--------------------|--------------------|------------------|----------|
|  | March 31,          |                    | 2007 vs. 2006    |          |
|  | 2007               | 2006               | Amount           | %        |
| Other income (expense):                                  |                    |                    |                  |          |
| Corporate interest income                                | \$ 1,705           | \$ 1,961           | \$ (256)         | (13)%    |
| Corporate interest expense                               | (37,791)           | (40,508)           | 2,717            | (7)%     |
| Gain on sales and impairment of investments              | 19,756             | 17,616             | 2,140            | 12 %     |
| Loss on early extinguishment of debt                     | —                  | (135)              | 135              | *        |
| Equity in income (loss) of investments and venture funds | 8,095              | (1,007)            | 9,102            | *        |
| Total other expense                                      | <u>\$ (8,235)</u>  | <u>\$ (22,073)</u> | <u>\$ 13,838</u> | <u>*</u> |

\* Percentage not meaningful

Total other expense for the three months ended March 31, 2007 primarily consisted of corporate interest expense resulting from the funding of the Harrisdirect and BrownCo acquisitions beginning in late 2005. Offsetting corporate interest expense was \$19.8 million in gain on sales and impairment of investments, which resulted from the sale of our investment in E\*TRADE Australia during the first quarter of 2007. Also offsetting corporate interest expense was \$8.1 million in income from equity method investments and venture funds for the three months ended March 31, 2007.

### *Income Tax Expense*

Income tax expense from continuing operations increased 18% to \$92.9 million during the three months ended March 31, 2007 compared to the same period in 2006. The increase in income tax expense was related to the increase in pre-tax income over the comparable period. Our effective tax rates for the three months ended March 31, 2007 and 2006 were 35.4% and 35.5%, respectively.

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**SEGMENT RESULTS REVIEW**

**Retail**

Retail segment income decreased 3% to \$171.5 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands, except for key metrics):

|   | Three Months Ended |                  | Variance          |             |
|---|--------------------|------------------|-------------------|-------------|
|   | March 31,          |                  | 2007 vs. 2006     |             |
|   | 2007               | 2006             | Amount            | %           |
| <b>Retail segment income:</b>                                 |                    |                  |                   |             |
| Net operating interest income after provision for loan losses | \$227,481          | \$205,920        | \$ 21,561         | 10 %        |
| Commission  | 123,305            | 135,864          | (12,559)          | (9)%        |
| Fees and service charges                                      | 54,203             | 53,344           | 859               | 2 %         |
| Gain on sales of loans and securities, net                    | 4,911              | 8,727            | (3,816)           | (44)%       |
| Other revenue   | 9,751              | 9,299            | 452               | 5 %         |
| Net segment revenue   | 419,651            | 413,154          | 6,497             | 2 %         |
| Total segment expense   | 248,193            | 235,820          | 12,373            | 5 %         |
| Total retail segment income                                   | <u>\$171,458</u>   | <u>\$177,334</u> | <u>\$ (5,876)</u> | <u>(3)%</u> |
| <b>Key Metrics:</b>   |                    |                  |                   |             |
| Retail client assets (dollars in billions)                    | \$ 200.5           | \$ 192.0         | \$ 8.5            | 4 %         |
| Customer cash and deposits (dollars in billions)              | \$ 36.0            | \$ 29.8          | \$ 6.2            | 21 %        |
| U.S. DARTS  | 141,238            | 159,199          | (17,961)          | (11)%       |
| International DARTS   | 28,798             | 21,960           | 6,838             | 31 %        |
| DARTs   | 170,036            | 181,159          | (11,123)          | (6)%        |
| Average commission per trade                                  | \$ 11.89           | \$ 12.10         | \$ (0.21)         | (2)%        |
| Average margin debt (dollars in billions)                     | \$ 6.9             | \$ 6.6           | \$ 0.3            | 5 %         |

Our retail segment generates revenue from investing, trading, banking and lending relationships with retail customers. These relationships essentially drive five sources of revenue including net operating interest income; commission; fees and service charges; gain on sales of loans and securities, net; and other revenue. Other revenue includes results from our stock plan administration products and services, as we ultimately service retail customers through these corporate relationships. Our geographically dispersed retail accounts grew 5% during the three months ended March 31, 2007 compared to the same period in 2006. We believe this growth is a result of the investments we have made in marketing, operations and service. As of March 31, 2007, we had approximately 3.6 million active investing and trading accounts and 0.9 million active deposit and lending accounts.

The slight decline in retail segment income during the first quarter of 2007 was the result of lower commission revenue and higher marketing spend offset by growth in net operating interest income.

Retail net operating interest income after provision for loan losses increased 10% to \$227.5 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase was driven by growth in customer cash and deposits, which generally translate into a lower cost of funds. The growth in customer cash and deposits of \$6.2 billion was largely the result of the growth in the Complete Savings Account.

Retail commission revenue decreased 9% to \$123.3 million for the three months ended March 31, 2007 compared to the same period in 2006. The decrease in commission revenue was primarily the result of lower trading volumes in the overall domestic equity market. Slightly offsetting this decline was an increase in our international commissions where DARTs increased 31% from 21,960 to 28,798 for the three months ended March 31, 2007 compared to the same period in 2006.

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Retail segment expense increased \$12.4 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase related primarily to our increased marketing spend as we expanded efforts to promote our products and services to the value-driven mass affluent customer.

### Institutional

Institutional segment income increased 49% to \$99.1 million for the three months ended March 31, 2007 compared to the same period in 2006, as shown in the following table (dollars in thousands, except for key metrics):

|   | Three Months Ended<br>March 31, |           | Variance<br>2007 vs. 2006 |        |
|---|---------------------------------|-----------|---------------------------|--------|
|   | 2007                            | 2006      | Amount                    | %      |
| <b>Institutional segment income:</b>  |                                 |           |                           |        |
| Net operating interest income after provision for loan losses               | \$141,919                       | \$108,672 | \$33,247                  | 31 %   |
| Commission  | 35,688                          | 40,005    | (4,317)                   | (11)%  |
| Fees and service charges  | 7,475                           | 6,791     | 684                       | 10 %   |
| Principal transactions  | 30,082                          | 30,692    | (610)                     | (2)%   |
| Gain on sales of loans and securities, net                                  | 12,464                          | 2,901     | 9,563                     | 330 %  |
| Other revenue   | 41                              | 111       | (70)                      | (63)%  |
| Net segment revenue   | 227,669                         | 189,172   | 38,497                    | 20 %   |
| Total segment expense   | 128,534                         | 122,754   | 5,780                     | 5 %    |
| Total institutional segment income  | \$ 99,135                       | \$ 66,418 | \$32,717                  | 49 %   |
| <b>Key Metrics:</b>   |                                 |           |                           |        |
| Total nonperforming loans receivable as a % of total gross loans receivable | 0.39%                           | 0.21%     | *                         | 0.18 % |
| Average revenue capture per 1,000 equity shares                             | \$ 0.576                        | \$ 0.277  | \$ 0.299                  | 108 %  |

\* Percentage not meaningful

Our institutional segment generates earnings from balance sheet management activities, market-making and global execution and settlement services. Balance sheet management activities include purchasing loan receivables from the retail segment as well as third parties, and leveraging these loans and retail customer cash and deposit relationships to generate additional net operating interest income. Retail trading order flow is leveraged by the institutional segment to generate additional revenue for the Company.

Net operating interest income after provision for loan losses increased 31% to \$141.9 million for the three months ended March 31, 2007 compared to the same period in 2006. This increase primarily was a result of growth in interest-earning assets, which are funded primarily by retail customer cash and deposit balances. These customer balances were kept on-balance sheet as a low-cost source of funding and then utilized by the institutional segment either to purchase interest-earning assets or pay down wholesale liabilities.

Institutional commissions decreased 11% to \$35.7 million for the three months ended March 31, 2007 compared to the same period in 2006. This decrease was due to lower trading volumes during the first quarter of 2007 compared to the same period in 2006. We provide institutional customers with global execution and settlement services, as well as worldwide access to research provided by third parties, in exchange for commissions based on negotiated rates, which differ by customer.

Gain on sales of loans and securities, net increased approximately \$9.6 million for the three months ended March 31, 2007 compared to the same period in 2006. We evaluate our portfolio of securities available-for-sale

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in light of changing market conditions and where appropriate, take steps intended to optimize our overall economic position. Based on this evaluation, we decided to sell certain securities, which resulted in a gain on sales of loans and securities, net of \$12.5 million for the three months ended March 31, 2007.

Total institutional segment expense increased 5% to \$128.5 million for the three months ended March 31, 2007 compared to the same period in 2006 and was predominantly related to an increase in professional services and occupancy and equipment expenses.

### BALANCE SHEET OVERVIEW

The following table sets forth the significant components of our consolidated balance sheet (dollars in thousands):

|  | March 31,<br>2007          | December 31,<br>2006       | Variance<br>2007 vs. 2006 |
|--|----------------------------|----------------------------|---------------------------|
| <b>Assets:</b>   |                            |                            |                           |
| Cash and equivalents <sup>(1)</sup>                          | \$ 1,605,984               | \$ 1,493,856               | 8 %                       |
| Trading securities   | 151,046                    | 178,600                    | (15)%                     |
| Available-for-sale mortgage-backed and investment securities | 16,458,481                 | 13,921,983                 | 18 %                      |
| Loans held-for-sale  | 193,385                    | 283,496                    | (32)%                     |
| Margin receivables   | 6,947,535                  | 6,828,448                  | 2 %                       |
| Loans receivable, net  | 29,671,642                 | 26,372,697                 | 13 %                      |
| Other assets <sup>(2)</sup>                                  | 5,107,009                  | 4,660,223                  | 10 %                      |
| <b>Total assets</b>  | <b><u>\$60,135,082</u></b> | <b><u>\$53,739,303</u></b> | <b>12 %</b>               |
| <b>Liabilities and shareholders' equity:</b>                 |                            |                            |                           |
| Deposits   | \$26,256,619               | \$24,071,012               | 9 %                       |
| Securities sold under agreements to repurchase               | 12,125,686                 | 9,792,422                  | 24 %                      |
| Customer payables  | 6,311,657                  | 6,182,672                  | 2 %                       |
| Other borrowings   | 6,560,501                  | 5,323,962                  | 23 %                      |
| Corporate debt <sup>(3)</sup>                                | 1,843,207                  | 1,842,169                  | 0 %                       |
| Accounts payable, accrued and other liabilities              | 2,686,386                  | 2,330,696                  | 15 %                      |
| <b>Total liabilities</b>                                     | <b>55,784,056</b>          | <b>49,542,933</b>          | <b>13 %</b>               |
| Shareholders' equity   | 4,351,026                  | 4,196,370                  | 4 %                       |
| <b>Total liabilities and shareholders' equity</b>            | <b><u>\$60,135,082</u></b> | <b><u>\$53,739,303</u></b> | <b>12 %</b>               |

(1) Includes balance sheet line items cash and equivalents and cash and investments required to be segregated under Federal or other regulations.

(2) Includes balance sheet line items property and equipment, net, goodwill, other intangibles, net and other assets.

(3) Includes balance sheet line items senior notes and mandatory convertible notes.

During the period, we re-presented our balance sheet to report margin receivables and customer payables directly on the face of the balance sheet. The remaining components of brokerage receivables and brokerage payables are now reported in the "Other assets" and "Accounts payable, accrued and other liabilities" line items, respectively.

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The margin receivables balance is a component of the margin debt balance, which is reported as a key retail metric of \$7.0 billion for both March 31, 2007 and 2006. The total margin debt balance is summarized as follows (dollars in thousands):

|  | March 31,<br>2007   | December 31,<br>2006 |
|--|---------------------|----------------------|
| Margin receivables                     | \$ 6,947,535        | \$ 6,828,448         |
| Margin held by third parties and other | 84,609              | 174,652              |
| Margin debt                            | <u>\$ 7,032,144</u> | <u>\$ 7,003,100</u>  |

The increase in total assets was primarily the result of growth in available-for-sale mortgage-backed and investment securities and loans receivable, net. The growth in available-for-sale mortgage-backed and investment securities was driven primarily by growth in mortgage-backed securities. The growth in loans receivable, net was the result of our continued focus on growing our residential mortgage loan portfolios, including one- to four-family mortgages and home equity loans.

The increase in total liabilities primarily was attributable to the increase in deposits and securities sold under agreements to repurchase. The \$2.2 billion increase in deposits was due primarily to the growth in the Complete Savings Account. The increase in securities sold under agreements to repurchase contributed to the growth of the loans receivable, net.

### Loans Receivable, Net

Loans receivable, net are summarized as follows (dollars in thousands):

|   | March 31,<br>2007   | December 31,<br>2006 | Variance<br>2007 vs. 2006 |
|---|---------------------|----------------------|---------------------------|
| Real estate loans:  |                     |                      |                           |
| One- to four-family   | \$13,360,842        | \$10,870,214         | 23 %                      |
| Home equity lines of credit ("HELOC"), Home equity installment loans ("HEIL") and other | 12,759,680          | 11,809,008           | 8 %                       |
| Consumer and other loans:   |                     |                      |                           |
| Recreational vehicle  | 2,182,334           | 2,292,356            | (5)%                      |
| Marine  | 621,368             | 651,764              | (5)%                      |
| Commercial  | 233,301             | 219,008              | 7 %                       |
| Credit card   | 109,559             | 128,583              | (15)%                     |
| Automobile  | 56,849              | 77,533               | (27)%                     |
| Other   | 2,940               | 3,706                | (21)%                     |
| Unamortized premiums, net   | 412,758             | 388,153              | 6 %                       |
| Allowance for loan losses   | (67,989)            | (67,628)             | 1 %                       |
| Total loans receivable, net   | <u>\$29,671,642</u> | <u>\$26,372,697</u>  | 13 %                      |

Loans receivable, net increased 13% to \$29.7 billion at March 31, 2007 from \$26.4 billion at December 31, 2006. We continue to focus on our growth in real estate loans while allowing our consumer loans to decline. We anticipate that our mortgage portfolio will continue to increase over time, and we believe this will improve our credit risk profile. We anticipate that recreational vehicle and marine loan balances will continue to decline over time due to our sale of Consumer Finance Corporation in 2005, and automobile loans will continue to decline due to our exit of the automobile origination business in 2004.

In recent months, there has been considerable attention in the financial and business media regarding rising delinquencies and default rates in the sub-prime<sup>(1)</sup> lending market. As a general matter, we do not originate or

(1) Defined as borrowers with FICO scores less than 620 at the time of origination.



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purchase sub-prime loans to hold on our balance sheet; however, in the normal course of purchasing large pools of mortgage loans, we invariably end up acquiring a de minimis amount of these loans. As of March 31, 2007, sub-prime loans represented less than one-fifth of one percent of our total loan portfolio.

During the first quarter of 2007, we entered into a credit default swap (“CDS”) on \$4.0 billion of our first-lien residential mortgage loan portfolio. A CDS provides, for a fee, an assumption by a third party of a portion of the credit risk related to the underlying loans. The CDS we entered into provides protection for losses in excess of 10 basis points, but not to exceed approximately 75 basis points. In addition, our regulatory risk-weighted assets were reduced as a result of this transaction because we transferred a portion of our credit risk to an unaffiliated third party.

### Allowance for Loan Losses

The allowance for loan losses is management’s estimate of credit losses inherent in our loan portfolio as of the balance sheet date. The estimate of the allowance for loan losses is based on a variety of factors, including the composition and quality of the portfolio; delinquency levels and trends; probable expected losses for the next twelve months; current and historical charge-off and loss experience; current industry charge-off and loss experience; the condition of the real estate market and geographic concentrations within the loan portfolio; the interest rate climate as it affects adjustable-rate loans; and general economic conditions. Determining the adequacy of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in future periods. In general, we believe the allowance for loan losses should be equal to at least twelve months of probable projected losses for all loan types. We believe this level is representative of probable losses inherent in the loan portfolio at the balance sheet date.

In determining the allowance for loan losses, we allocate a portion of the allowance to various loan products based on an analysis of individual loans and pools of loans. However, the entire allowance is available to absorb credit losses inherent in the total loan portfolio as of the balance sheet date.

The following table presents the allowance for loan losses by major loan category (dollars in thousands):

|                   | Consumer & Other |   | Real Estate |  | Total     |  |
|-------------------|------------------|---|-------------|--|-----------|--|
|                   | Allowance        | Allowance as %<br>of Consumer and<br>Other Loans Receivable | Allowance   | Allowance as %<br>of Real Estate<br>Loans Receivable | Allowance | Allowance as %<br>of Total<br>Loans Receivable |
| March 31, 2007    | \$23,863         | 0.73%   | \$44,126    | 0.17%  | \$67,989  | 0.23%  |
| December 31, 2006 | \$28,197         | 0.82%   | \$39,431    | 0.17%  | \$67,628  | 0.26%  |

The following table provides an analysis of the allowance for loan losses for the three months ended March 31, 2007 and 2006 (dollars in thousands):

|  | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2007                            | 2006      |
| Allowance for loan losses, beginning of period | \$ 67,628                       | \$ 63,286 |
| Provision for loan losses                      | 21,186                          | 10,197    |
| Charge-offs                                    | (26,444)                        | (14,859)  |
| Recoveries                                     | 5,619                           | 5,885     |
| Net charge-offs                                | (20,825)                        | (8,974)   |
| Allowance for loan losses, end of period       | \$ 67,989                       | \$ 64,509 |

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Losses are recognized when it is probable that a loss will be incurred. Our policy is to charge off closed-end consumer loans when the loan is 120 days delinquent or when we determine that collection is not probable. For first-lien mortgages, a charge-off is recognized when we foreclose on the property. For revolving loans, our policy is to charge off loans when collection is not probable or the loan has been delinquent for 180 days.

During the three months ended March 31, 2007, the allowance for loan losses increased by \$0.4 million from the level at December 31, 2006. The allowance increased by \$4.7 million related to the growth of the real estate portfolio. Offsetting this increase was a decrease in the allowance for loan losses of \$4.3 million related to the decline in the size of the consumer loan portfolio.

Net charge-offs for the three months ended March 31, 2007 compared to the same period in 2006 increased by \$11.9 million. The overall increase was primarily due to higher net charge-offs on real estate loans. The increase in real estate loan charge-offs was due to the growth of the portfolio. Annualized net charge-offs as a percentage of average loans receivable, net were 0.30% at March 31, 2007 compared to 0.22% at December 31, 2006.

### *Nonperforming Assets*

We classify loans as nonperforming when full and timely collection of interest or principal becomes uncertain or when they are 90 days past due. The following table shows the comparative data for nonperforming loans and assets (dollars in thousands):

|   | March 31,<br>2007 | December 31,<br>2006 |
|---|-------------------|----------------------|
| Real estate loans   | \$110,544         | \$ 66,435            |
| Consumer and other loans  | 5,955             | 8,906                |
| Total nonperforming loans, net  | 116,499           | 75,341               |
| Real estate owned ("REO") and other repossessed assets, net                             | 19,808            | 12,904               |
| Total nonperforming assets, net   | \$136,307         | \$ 88,245            |
| Total nonperforming loans receivable as a percentage of total gross loans receivable    | 0.39%             | 0.28%                |
| Total allowance for loan losses as a percentage of total nonperforming loans receivable | 58.68%            | 90.52%               |

We expect nonperforming loan levels to fluctuate over time due to portfolio growth, portfolio seasoning and resolution through collections, sales or charge-offs. The performance of any loan can be affected by external factors, such as economic conditions or factors particular to the borrower.

During the three months ended March 31, 2007, our nonperforming assets, net increased \$48.1 million from \$88.2 million at December 31, 2006. The increase was attributed to an increase in nonperforming real estate loans and REO and other repossessed assets, net of \$51.0 million, offset by a decrease in nonperforming consumer and other loans of \$2.9 million. These trends are primarily the result of our targeted growth in real estate loans as well as the seasoning of the real estate loan acquisitions made in prior periods.

The allowance as a percentage of total nonperforming loans receivable, net decreased from 91% at December 31, 2006 to 59% at March 31, 2007. Our total loan portfolio has shifted towards a larger concentration of mortgage loans, where the risk of loss is generally less than the risk of loss on a consumer loan. As such, the total allowance as a percentage of nonperforming assets decreased.

In addition to nonperforming assets in the table above, we monitor loans where a borrower's past credit history casts doubt on their ability to repay a loan ("Special Mention" loans). Special Mention loans represented \$357.3 million, or 1%, and \$261.5 million, or 1%, of the total loan portfolio at March 31, 2007 and December 31, 2006, respectively, and are generally secured by real estate assets, reducing the potential loss should they become nonperforming. These loans are actively monitored, continue to accrue interest and remain a component of the loans receivable balance. The increase in Special Mention loans was due primarily to an

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increase in the 30-day delinquency category of mortgage loans. We expect migration from this category to more serious delinquency classifications to increase over time consistent with the current consumer credit environment; however, we do not expect this migration to be significant.

### Available-for-Sale Mortgage-Backed and Investment Securities

Available-for-sale securities are summarized as follows (dollars in thousands):

|  | March 31,<br>2007   | December 31,<br>2006 | Variance<br>2007 vs. 2006 |
|--|---------------------|----------------------|---------------------------|
| <b>Mortgage-backed securities:</b>                       |                     |                      |                           |
| Backed by U.S. government sponsored and Federal agencies | \$10,377,478        | \$ 9,109,307         | 14 %                      |
| Collateralized mortgage obligations and other            | 1,830,916           | 1,108,385            | 65 %                      |
| Total mortgage-backed securities                         | <u>12,208,394</u>   | <u>10,217,692</u>    | 19 %                      |
| <b>Investment securities:</b>                            |                     |                      |                           |
| Asset-backed securities                                  | 2,608,003           | 2,161,728            | 21 %                      |
| <b>Publicly traded equity securities:</b>                |                     |                      |                           |
| Preferred stock  | 380,236             | 458,674              | (17)%                     |
| Corporate investments                                    | 37,515              | 24,139               | 55 %                      |
| FHLB stock   | 296,170             | 244,212              | 21 %                      |
| Other  | 928,163             | 815,538              | 14 %                      |
| Total investment securities                              | <u>4,250,087</u>    | <u>3,704,291</u>     | 15 %                      |
| Total available-for-sale securities                      | <u>\$16,458,481</u> | <u>\$13,921,983</u>  | 18 %                      |

Available-for-sale securities represented 27% and 26% of total assets at March 31, 2007 and December 31, 2006, respectively. Available-for-sale securities increased 18% to \$16.5 billion at March 31, 2007 compared to December 31, 2006, due primarily to the growth in our asset-backed securities portfolio. We evaluate our available-for-sale securities in light of changing market conditions and other factors and, where appropriate, take steps intended to improve our overall position. Based on this evaluation, we decided to grow the mortgage-backed and asset-backed securities portfolios, which resulted in an increase of \$2.4 billion in these portfolios during the three months ended March 31, 2007.

As interest rates increase, the fair value of fixed-rate available-for-sale securities decreases and vice versa. The fair value of the portfolio will be adversely impacted in the future if long-term interest rates continue to rise. Net unrealized gains and losses in available-for-sale securities are included in shareholders' equity as accumulated other comprehensive income or loss, net of tax.

### Deposits

Deposits are summarized as follows (dollars in thousands):

|   | March 31,<br>2007   | December 31,<br>2006 | Variance<br>2007 vs. 2006 |
|---|---------------------|----------------------|---------------------------|
| Sweep deposit accounts                          | \$10,803,331        | \$10,837,124         | (0)%                      |
| Money market and savings accounts               | 9,879,772           | 7,634,241            | 29 %                      |
| Certificates of deposit <sup>(1)</sup>          | 4,738,123           | 4,737,253            | 0 %                       |
| Brokered certificates of deposit <sup>(2)</sup> | 447,403             | 483,777              | (8)%                      |
| Checking accounts                               | 387,990             | 378,617              | 2 %                       |
| Total deposits                                  | <u>\$26,256,619</u> | <u>\$24,071,012</u>  | 9 %                       |

(1) Represents retail certificates of deposit including retail brokered certificates of deposit.

(2) Represents institutional certificates of deposit.

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Deposits represented 47% and 49% of total liabilities at March 31, 2007 and December 31, 2006, respectively. Deposits increased \$2.2 billion to \$26.3 billion at March 31, 2007 compared to December 31, 2006, driven by a \$2.2 billion increase in money market and savings accounts.

The increase in deposits is primarily the result of the growth in our Complete Savings Account. This new product has driven measurable growth in cash from new and existing customers. Deposits generally provide us the benefit of lower interest costs, compared with wholesale funding alternatives.

The deposits balance is a component of the total customer cash and deposits balance reported as a customer activity metric of \$36.0 billion for the three months ended March 31, 2007. The total customer cash and deposits balance is summarized as follows (dollars in thousands):

|  | <u>March 31,</u><br><u>2007</u> | <u>December 31,</u><br><u>2006</u> | <u>Variance</u><br><u>2007 vs. 2006</u> |
|--|---------------------------------|------------------------------------|---|
| Deposits   | \$26,256,619                    | \$24,071,012                       | 9 %                                     |
| Less: brokered certificates of deposit                 | (447,403)                       | (483,777)                          | (8)%                                    |
| Deposits excluding brokered certificates of deposit    | 25,809,216                      | 23,587,235                         | 9 %                                     |
| Customer payables                                      | 6,311,657                       | 6,182,672                          | 2 %                                     |
| Customer cash balances held by third parties and other | 3,914,037                       | 3,819,860                          | 2 %                                     |
| Total customer cash and deposits                       | <u>\$36,034,910</u>             | <u>\$33,589,767</u>                | 7 %                                     |

### *Securities Sold Under Agreements to Repurchase and Other Borrowings*

Securities sold under agreements to repurchase and other borrowings are summarized as follows (dollars in thousands):

|  | <u>March 31,</u><br><u>2007</u> | <u>December 31,</u><br><u>2006</u> | <u>Variance</u><br><u>2007 vs. 2006</u> |
|--|---------------------------------|------------------------------------|---|
| Securities sold under agreements to repurchase | <u>\$12,125,686</u>             | <u>\$9,792,422</u>                 | 24%                                     |
| FHLB advances                                  | \$ 6,023,124                    | \$4,865,466                        | 24%                                     |
| Subordinated debentures                        | 425,522                         | 385,502                            | 10%                                     |
| Other  | 111,855                         | 72,994                             | 53%                                     |
| Total other borrowings                         | <u>\$ 6,560,501</u>             | <u>\$5,323,962</u>                 | 23%                                     |

Securities sold under agreements to repurchase increased by 24% at March 31, 2007 compared to December 31, 2006. Securities sold under agreements to repurchase coupled with FHLB advances are the primary wholesale funding sources of the Bank. The Bank used these wholesale sources along with deposit growth to fund the increase in loans receivable. Other borrowings represented 12% and 11% of total liabilities at March 31, 2007 and December 31, 2006, respectively. The increase of \$1.2 billion during the three months ended March 31, 2007 was due primarily to an increase in FHLB advances. We actively manage our funding sources and determine the optimal mix based on pricing, liquidity and capacity during each period.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our liquidity and capital resources enable us to fund our operating activities, finance acquisitions and grow our assets. Cash flows are derived from our operations in the retail and institutional segments and our capital market activities. The segment cash flows provide capital to fund growth in our regulated subsidiaries. The Company's cash and equivalents balance increased to \$1.2 billion for the period ended March 31, 2007.

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### ***Corporate Debt***

Our current senior debt ratings are Ba2 (positive outlook) by Moody's Investor Service, BB- (stable) by Standard & Poor's and BB (high) by Dominion Bond Rating Service ("DBRS"). The Company's long-term deposit ratings are Baa3 (positive outlook) by Moody's Investor Service, BB+ (stable) by Standard & Poor's and BBB (low) by DBRS. A significant change in these ratings may impact the rate and availability of future borrowings.

### ***Liquidity Available from Subsidiaries***

Liquidity available to the Company from its subsidiaries, other than Converging Arrows, Inc. ("Converging Arrows"), is limited by regulatory requirements. Converging Arrows is a subsidiary of the parent company. At March 31, 2007, Converging Arrows had \$125.7 million of cash and investment securities available as a source of liquidity for the parent company. Converging Arrows is not restricted in its dealings with the parent company and may transfer funds to the parent company without regulatory approval. In addition to Converging Arrows, brokerage and banking subsidiaries may provide liquidity to the parent; however, they are restricted by regulatory guidelines.

E\*TRADE Bank is prohibited by regulations from lending to the parent company. At March 31, 2007, E\*TRADE Bank had approximately \$179.9 million of capital available for dividend declaration without regulatory approval while still maintaining "well capitalized" status. E\*TRADE Bank is also required by Office of Thrift Supervision ("OTS") regulations to maintain tangible capital of at least 1.50% of tangible assets. E\*TRADE Bank satisfied this requirement at March 31, 2007 and December 31, 2006.

Brokerage subsidiaries are required to maintain net capital equal to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions. At March 31, 2007 and December 31, 2006, all of our brokerage subsidiaries met their minimum net capital requirements. The Company's broker-dealer subsidiaries had excess net capital of \$695.6 million at March 31, 2007.

### ***Other Sources of Liquidity***

We maintain committed and uncommitted financing facilities with banks totaling \$250.0 million to meet corporate liquidity needs and \$576.0 million to meet margin lending needs. There were no outstanding balances, and the full \$826.0 million was available under these lines at March 31, 2007 and December 31, 2006.

We rely on borrowed funds, such as FHLB advances and securities sold under agreements to repurchase, to provide liquidity for the Bank. At March 31, 2007, the Bank had approximately \$10.5 billion in additional borrowing capacity.

### ***Other Liquidity Matters***

We currently anticipate that our available cash resources and credit will be sufficient to meet our anticipated working capital and capital expenditure requirements for at least the next 12 months. We may need to raise additional funds in order to support more rapid expansion, develop new or enhanced products and services, respond to competitive pressures, acquire businesses or technologies or take advantage of unanticipated opportunities.

## **SUMMARY OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon the financial results of the Company. We believe that of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: allowance for loan losses and uncollectible margin loans; classification and valuation of certain investments; valuation and accounting for financial derivatives; estimates of effective tax rate; deferred taxes and valuation allowances; and valuation of goodwill and other intangibles. These are more fully described in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2006.

## GLOSSARY OF TERMS

*Active Trader*—The customer segment that includes those who execute 30 or more trades per quarter.

*Adjusted total assets*—Bank-only assets composed of total assets plus/(less) unrealized losses (gains) on available-for-sale securities, less deferred tax assets, goodwill and certain other intangible assets.

*Average commission per trade*—Total retail segment commission revenue divided by total number of retail trades.

*Average equity to average total assets*—Average total shareholders' equity divided by average total assets.

*Bank*—ETB Holdings, Inc. ("ETBH"), the entity that is our bank holding company and parent to E\*TRADE Bank and ETGAM.

*Basis point*—One one-hundredth of a percentage point.

*Cash flow hedge*—A financial derivative instrument designated in a hedging relationship that mitigates exposure to variability in expected future cash flows attributable to a particular risk.

*Charge-off*—The result of removing a loan or portion of a loan from an entity's balance sheet because the loan is considered to be uncollectible.

*Compensation and benefits as a percentage of revenue*—Total compensation and benefits expense divided by total net revenue.

*Contract for difference ("CFDs")*—A derivative based on an underlying stock or index that covers the difference between the nominal value at the opening of a trade and at the close of a trade. A CFD is researched and traded in the same manner as a stock.

*Corporate investments*—Primarily equity investments held at the parent company level that are not related to the ongoing business of the Company's operating subsidiaries.

*Customer cash and deposits*—Customer cash, deposits, customer payables and money market balances, including those held by third parties.

*Daily average revenue trades ("DARTs")*—Total revenue trades in a period divided by the number of trading days during that period.

*Derivative*—A financial instrument or other contract the price of which is directly dependent upon the value of one or more underlying securities, interest rates or any agreed upon pricing index. Derivatives cover a wide assortment of financial contracts, including forward contracts, options and swaps.

*E\*TRADE Complete*—An integrated investing, trading, banking and lending product that allows customers to manage their relationships with the Company through one account. E\*TRADE Complete helps customers optimize cash and credit by utilizing tools designed to inform them of whether or not they are receiving the most appropriate rates for their cash and paying the most appropriate rates for credit.

*Enterprise interest-bearing liabilities*—Liabilities such as customer deposits, repurchase agreements, other borrowings and advances from the FHLB, certain customer credit balances and stock loan programs on which the Company pays interest; excludes customer money market balances held by third parties.

*Enterprise interest-earning assets*—Consists of the primary interest-earning assets of the Company and includes: loans receivable, mortgage-backed and available-for-sale securities, margin receivables, stock borrow balances, and cash required to be segregated under regulatory guidelines that earn interest for the Company.

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*Enterprise net interest income*—The taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties.

*Enterprise net interest spread*—The taxable equivalent rate earned on average enterprise interest-earning assets less the rate paid on average enterprise interest-bearing liabilities, excluding corporate interest-earning assets and liabilities, stock conduit and cash held by third parties.

*Exchange-traded funds*—A fund that invests in a group of securities and trades like an individual stock on an exchange.

*Fair value hedge*—A financial derivative instrument designated in a hedging relationship that mitigates exposure to changes in the fair value of a recognized asset or liability or a firm commitment.

*GAAP*—Accounting principles generally accepted in the United States of America.

*Interest rate cap*—An options contract that puts an upper limit on a floating exchange rate. The writer of the cap has to pay the holder of the cap the difference between the floating rate and the upper limit when that upper limit is breached. There is usually a premium paid by the buyer of such a contract.

*Interest rate floor*—An options contract that puts a lower limit on a floating exchange rate. The writer of the floor has to pay the holder of the floor the difference between the floating rate and the lower limit when that lower limit is breached. There is usually a premium paid by the buyer of such a contract.

*Interest rate swaps*—Contracts that are entered into primarily as an asset/liability management strategy to reduce interest rate risk. Interest rate swap contracts are exchanges of interest rate payments, such as fixed-rate payments for floating-rate payments, based on notional principal amounts.

*Main Street Investor*—The customer segment that includes those who execute less than 30 trades per quarter and hold less than \$50,000 in assets in combined retail accounts.

*Margin debt*—The extension of credit to brokerage customers of the Company, on and off balance sheet, where the loan is secured with securities owned by the customer.

*Mass Affluent*—The customer segment that includes those who hold \$50,000 or more in assets in combined retail accounts.

*Net Present Value of Equity (“NPVE”)*—The present value of expected cash inflows from existing assets, minus the present value of expected cash outflows from existing liabilities, plus the expected cash inflows and outflows from existing derivatives and forward commitments. This calculation is performed for E\*TRADE Bank.

*Nonperforming assets*—Assets that do not earn income, including those originally acquired to earn income (delinquent loans) and those not intended to earn income (REO). Loans are classified as nonperforming when full and timely collection of interest and principal becomes uncertain or when the loans are 90 days past due.

*Notional amount*—The specified dollar amount underlying a derivative on which the calculated payments are based.

*Operating expenses*—Total expense excluding interest, as shown on the Company’s consolidated statement of income.

*Operating margin*—Income before other income (expense), income taxes, minority interest, discontinued operations and cumulative effect of accounting change.

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*Operating margin (%)*—Percentage of net revenue that goes to income before other income (expense), income taxes, minority interest, discontinued operations and cumulative effect of accounting change. It is calculated by dividing our income before other income (expense), income taxes, minority interest, discontinued operations and cumulative effect of accounting change by our total net revenue.

*Options*—Contracts that grant the purchaser, for a premium payment, the right, but not the obligation, to either purchase or sell the associated financial instrument at a set price during a period or at a specified date in the future.

*Organic*—Business related to new and existing customers as opposed to acquisitions.

*Principal transactions*—Transactions that primarily consist of revenue from market-making activities.

*Real-estate owned repossessed assets ("REO")*—Ownership of real property by the Company, generally acquired as a result of foreclosure.

*Repurchase agreement*—An agreement giving the seller of an asset the right or obligation to buy back the same or similar securities at a specified price on a given date. These agreements are generally collateralized by mortgage-backed or investment-grade securities.

*Retail deposits*—Balances of retail customer cash held at the Bank; excludes brokered certificates of deposit.

*Retail client assets*—Market value of all client assets held by the Company including security holdings, customer cash and deposits and vested unexercised options.

*Return on average total assets*—Annualized net income from continuing operations divided by average assets.

*Return on average total shareholders' equity*—Annualized net income from continuing operations divided by average shareholders' equity.

*Revenue growth*—The difference between the current and prior comparable period total net revenue divided by the prior comparable period total net revenue.

*Risk-weighted assets*—Primarily computed by the assignment of specific risk-weightings assigned by the OTS to assets and off-balance sheet instruments for capital adequacy calculations. This calculation is for E\*TRADE Bank only.

*Stock conduit*—The borrowing of shares from a Broker-Dealer and subsequently lending the same shares to another Broker-Dealer netting a fee.

*Sweep deposit accounts*—Accounts with the functionality to transfer brokerage cash balances to and from an FDIC-insured money market account at the Bank.

*Taxable equivalent interest adjustment*—The operating interest income earned on certain assets is completely or partially exempt from federal and/or state income tax. As such, these tax-exempt instruments typically yield lower returns than a taxable investment. To provide more meaningful comparison of yields and margins for all interest-earning assets, the interest income earned on tax exempt assets is increased to make it fully equivalent to interest income on other taxable investments. This adjustment is done for the analytic purposes in the net enterprise interest income/spread calculation and is not made on the consolidated statement of income, as that is not permitted under GAAP.



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*Tier 1 Capital*—Adjusted equity capital used in the calculation of capital adequacy ratios at E\*TRADE Bank as required by the OTS. Tier 1 capital equals: total shareholder’s equity at E\*TRADE Bank, plus/(less) unrealized losses (gains) on available-for-sale securities and cash flow hedges, less deferred tax assets, goodwill and certain other intangible assets.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discussion about our market risk disclosure includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 1A. "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2006 and as updated in this report. Market risk is our exposure to changes in interest rates, foreign exchange rates and equity and commodity prices. Our exposure to interest rate risk is primarily related to interest-earning assets and interest-bearing liabilities.

#### *Interest Rate Risk*

The management of interest rate risk is essential to profitability. Interest rate risk is our exposure to changes in interest rates. In general, we manage our interest rate risk by balancing variable-rate and fixed-rate assets, liabilities and we utilize derivatives in a way that reduces our overall exposure to changes in interest rates. In recent years, we have managed our interest rate risk to achieve a minimum to moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations. Exposure to interest rate risk requires management to make complex assumptions regarding maturities, market interest rates and customer behavior. Changes in interest rates, including the following, could impact interest income and expense:

- Interest-earning assets and interest-bearing liabilities may re-price at different times or by different amounts creating a mismatch.
- The yield curve may flatten or change shape affecting the spread between short- and long-term rates. Widening or narrowing spreads could impact net interest income.
- Market interest rates may influence prepayments resulting in maturity mismatches. In addition, prepayments could impact yields as premium and discounts amortize.

Exposure to market risk is dependent upon the distribution and composition of interest-earning assets, interest-bearing liabilities and derivatives. The differing risk characteristics of each product are managed to mitigate our exposure to interest rate fluctuations. At March 31, 2007, 92% of our total assets were operating interest-earning assets.

At March 31, 2007, approximately 68% of our total assets were residential mortgages and available-for-sale mortgage-backed and asset-backed securities. The values of these assets are sensitive to changes in interest rates, as well as expected prepayment levels. As interest rates increase, fixed rate residential mortgages and mortgage-backed securities tend to exhibit lower prepayments. The inverse is true in a falling rate environment.

Our current strategy is to retain more originated mortgage loans on the balance sheet. When mortgage loans prepay, mortgage origination costs are written off. Depending on the timing of the prepayment, the write-offs of mortgage origination costs may result in lower than anticipated yields. E\*TRADE Bank's Asset Liability Committee ("ALCO") reviews estimates of the impact of changing market rates on loan production volumes and prepayments. This information is incorporated into our interest rate risk management strategy.

We held \$151.0 million in trading securities as of March 31, 2007. These securities and the associated interest rate risk are not material to the Company's financial position, results of operations, or cash flows.

Our liability structure consists of transactional deposit relationships, such as savings and money market accounts; certificates of deposit; securities sold under agreements to repurchase; customer payables; wholesale collateralized borrowings from the FHLB and other entities; and long term notes. Our transactional deposit accounts and customer payables tend to be less rate-sensitive than wholesale borrowings. Agreements to repurchase securities and money market accounts re-price as interest rates change. Certificates of deposit re-price over time depending on maturities. FHLB advances and long-term notes generally have fixed rates.

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### **Derivative Financial Instruments**

We use derivative financial instruments to help manage our interest rate risk. Interest rate swaps involve the exchange of fixed-rate and variable-rate interest payments between two parties based on a contractual underlying notional amount, but do not involve the exchange of the underlying notional amounts. Option products are utilized primarily to decrease the market value changes resulting from the prepayment dynamics of the mortgage portfolio, as well as to protect against increases in funding costs. The types of options employed include Cap Options (“Caps”) and Floor Options (“Floors”), “Payor Swaptions” and “Receiver Swaptions.” Caps mitigate the market risk associated with increases in interest rates while Floors mitigate the risk associated with decreases in market interest rates. Similarly, Payor and Receiver Swaptions mitigate the market risk associated with the respective increases and decreases in interest rates. See derivative financial instruments discussion at Note 7—Accounting for Derivative Financial Instruments and Hedging Activities in Item 1. Consolidated Financial Statements.

For mortgage loans intended to be sold, Interest Rate Lock Commitments (“IRLCs”) are considered derivatives with changes in fair value recorded in earnings. IRLCs are commitments issued to borrowers that lock in an interest rate now for a loan closing in one to three months. These locks, initially recorded with a fair value of zero, will fluctuate in value during the lock period as market interest rates change. See mortgage banking activities discussion at Note 7—Accounting for Derivative Financial Instruments and Hedging Activities in Item 1. Consolidated Financial Statements.

### **Scenario Analysis**

Scenario analysis is an advanced approach to estimating interest rate risk exposure. Under the Net Present Value of Equity (“NPVE”) approach, the present value of all existing assets, liabilities, derivatives and forward commitments are estimated and then combined to produce a NPVE figure. The sensitivity of this value to changes in interest rates is then determined by applying alternative interest rate scenarios, which include, but are not limited to, instantaneous parallel shifts up 100, 200 and 300 basis points and down 100 and 200 basis points. The NPVE method is used at the E\*TRADE Bank level and not for the Company. During the period ended March 31, 2007, E\*TRADE Clearing LLC (“ETC”) became a wholly-owned operating subsidiary of E\*TRADE Bank.

E\*TRADE Bank has 96% and 81% of our operating interest-earning assets at March 31, 2007 and December 31, 2006, respectively, and holds 97% and 79% of our operating interest-bearing liabilities at March 31, 2007 and December 31, 2006, respectively. The sensitivity of NPVE at March 31, 2007 and December 31, 2006 and the limits established by E\*TRADE Bank’s Board of Directors are listed below (dollars in thousands):

| Parallel Change in Interest Rates (bps) | Change in NPVE                |            |                   |            | Board Limit |
|---|-------------------------------|------------|-------------------|------------|-------------|
|   | March 31, 2007 <sup>(1)</sup> |            | December 31, 2006 |            |             |
|   | Amount                        | Percentage | Amount            | Percentage |             |
| +300                                    | \$ (532,716)                  | (14)%      | \$ (52,325)       | (2)%       | (55)%       |
| +200                                    | \$ (326,507)                  | (8)%       | \$ (32,680)       | (1)%       | (30)%       |
| +100                                    | \$ (137,224)                  | (4)%       | \$ (15,303)       | (1)%       | (20)%       |
| -100                                    | \$ (106,368)                  | (3)%       | \$ (159,618)      | (6)%       | (20)%       |
| -200                                    | \$ (519,518)                  | (13)%      | \$ (560,142)      | (20)%      | (30)%       |

<sup>(1)</sup> Amounts and percentages include ETC.

Under criteria published by the OTS, E\*TRADE Bank’s overall interest rate risk exposure at March 31, 2007 was characterized as “minimum.” We actively manage our interest rate risk positions. As interest rates change, we will re-adjust our strategy and mix of assets, liabilities and derivatives to optimize our position. For example, a 100 basis points increase in rates may not result in a change in value as indicated above. The ALCO monitors E\*TRADE Bank’s interest rate risk position.

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***Other Market Risk***

*Equity Security Risk*

Equity securities risk is the risk of potential loss from investing in public and private equity securities including foreign currency exchange risk. We hold equity securities for investment purposes and in trading securities for market-making purposes. The foreign currency exchange risk associated with these investments is not material to the Company. For investment purposes, we currently hold publicly traded equity securities, in which we had gross unrealized gains of \$24.5 million as of March 31, 2007. As each security's market price fluctuates, we are exposed to risk of a loss with respect to these unrealized gains. See publicly traded equity securities discussion at Note 5—Available-for-Sale Mortgage-Backed and Investment Securities in Item 1. Consolidated Financial Statements.

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## PART I—FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INCOME**  
**(In thousands, except per share amounts)**  
**(Unaudited)**

|  | Three Months Ended |            |
|--|--------------------|------------|
|  | March 31,          |            |
|  | 2007               | 2006       |
| Revenue:   |                    |            |
| Operating interest income  | \$ 829,795         | \$ 594,294 |
| Operating interest expense   | (439,209)          | (269,505)  |
| Net operating interest income  | 390,586            | 324,789    |
| Provision for loan losses  | (21,186)           | (10,197)   |
| Net operating interest income after provision for loan losses                  | 369,400            | 314,592    |
| Commission   | 158,993            | 175,869    |
| Fees and service charges   | 59,498             | 57,862     |
| Principal transactions   | 30,082             | 30,692     |
| Gain on sales of loans and securities, net                                     | 17,375             | 11,628     |
| Other revenue  | 9,650              | 7,706      |
| Total non-interest income  | 275,598            | 283,757    |
| Total net revenue  | 644,998            | 598,349    |
| Expense excluding interest:  |                    |            |
| Compensation and benefits  | 123,782            | 115,988    |
| Clearing and servicing   | 67,252             | 63,288     |
| Advertising and market development   | 45,592             | 34,781     |
| Communications   | 26,156             | 31,408     |
| Professional services  | 24,985             | 27,755     |
| Depreciation and amortization  | 19,383             | 18,789     |
| Occupancy and equipment  | 23,579             | 20,504     |
| Amortization of other intangibles  | 10,268             | 11,332     |
| Facility restructuring and other exit activities                               | 733                | (253)      |
| Other  | 32,675             | 31,005     |
| Total expense excluding interest   | 374,405            | 354,597    |
| Income before other income (expense), income taxes and discontinued operations | 270,593            | 243,752    |
| Other income (expense):  |                    |            |
| Corporate interest income  | 1,705              | 1,961      |
| Corporate interest expense   | (37,791)           | (40,508)   |
| Gain on sales and impairment of investments                                    | 19,756             | 17,616     |
| Loss on early extinguishment of debt   | —                  | (135)      |
| Equity in income (loss) of investments and venture funds                       | 8,095              | (1,007)    |
| Total other expense  | (8,235)            | (22,073)   |
| Income before income taxes and discontinued operations                         | 262,358            | 221,679    |
| Income tax expense   | 92,948             | 78,695     |
| Net income from continuing operations  | 169,410            | 142,984    |
| Loss from discontinued operations, net of tax                                  | —                  | (513)      |
| Net income   | \$ 169,410         | \$ 142,471 |
| Basic earnings per share from continuing operations                            | \$ 0.40            | \$ 0.34    |
| Basic earnings (loss) per share from discontinued operations                   | —                  | (0.00)     |
| Basic net earnings per share   | \$ 0.40            | \$ 0.34    |
| Diluted earnings per share from continuing operations                          | \$ 0.39            | \$ 0.33    |
| Diluted earnings (loss) per share from discontinued operations                 | —                  | (0.00)     |
| Diluted net earnings per share   | \$ 0.39            | \$ 0.33    |
| Shares used in computation of per share data:                                  |                    |            |
| Basic  | 423,786            | 414,679    |
| Diluted  | 437,535            | 432,302    |

See accompanying notes to consolidated financial statements

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**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEET**  
**(In thousands, except share amounts)**  
**(Unaudited)**

|  | March 31,<br>2007    | December 31,<br>2006 |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| Cash and equivalents   | \$ 1,194,981         | \$ 1,212,234         |
| Cash and investments required to be segregated under Federal or other regulations  | 411,003              | 281,622              |
| Trading securities   | 151,046              | 178,600              |
| Available-for-sale mortgage-backed and investment securities (includes securities pledged to creditors with the right to sell or repledge of \$13,484,424 at March 31, 2007 and \$11,087,961 at December 31, 2006) | 16,458,481           | 13,921,983           |
| Loans held-for-sale  | 193,385              | 283,496              |
| Margin receivables   | 6,947,535            | 6,828,448            |
| Loans receivable, net (net of allowance for loan losses of \$67,989 at March 31, 2007 and \$67,628 at December 31, 2006)   | 29,671,642           | 26,372,697           |
| Property and equipment, net  | 341,148              | 318,389              |
| Goodwill   | 2,084,974            | 2,072,920            |
| Other intangibles, net   | 461,694              | 471,933              |
| Other assets   | 2,219,193            | 1,796,981            |
| Total assets   | <u>\$ 60,135,082</u> | <u>\$ 53,739,303</u> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                      |                      |
| <b>Liabilities:</b>  |                      |                      |
| Deposits   | \$ 26,256,619        | \$ 24,071,012        |
| Securities sold under agreements to repurchase   | 12,125,686           | 9,792,422            |
| Customer payables  | 6,311,657            | 6,182,672            |
| Other borrowings   | 6,560,501            | 5,323,962            |
| Senior notes   | 1,401,383            | 1,401,592            |
| Mandatory convertible notes  | 441,824              | 440,577              |
| Accounts payable, accrued and other liabilities  | 2,686,386            | 2,330,696            |
| Total liabilities  | <u>55,784,056</u>    | <u>49,542,933</u>    |
| <b>Shareholders' equity:</b>   |                      |                      |
| Common stock, \$0.01 par value, shares authorized: 600,000,000; shares issued and outstanding: 427,161,994 at March 31, 2007 and 426,304,136 at December 31, 2006  | 4,272                | 4,263                |
| Additional paid-in capital ("APIC")  | 3,192,508            | 3,184,290            |
| Retained earnings  | 1,363,796            | 1,209,289            |
| Accumulated other comprehensive loss   | (209,550)            | (201,472)            |
| Total shareholders' equity   | <u>4,351,026</u>     | <u>4,196,370</u>     |
| Total liabilities and shareholders' equity   | <u>\$ 60,135,082</u> | <u>\$ 53,739,303</u> |

See accompanying notes to consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**  
**(In thousands)**  
**(Unaudited)**

|  | Three Months Ended |                  |
|--|--------------------|------------------|
|  | March 31,          |                  |
|  | 2007               | 2006             |
| Net income   | \$169,410          | \$142,471        |
| Other comprehensive income (loss)  |                    |                  |
| Available-for-sale securities:   |                    |                  |
| Unrealized gains (losses), net   | 6,889              | (56,641)         |
| Less impact of realized gains (transferred out of accumulated other comprehensive loss) and included in net income, net                                | (11,168)           | (12,870)         |
| Net change from available-for-sale securities  | (4,279)            | (69,511)         |
| Cash flow hedging instruments:   |                    |                  |
| Unrealized gains (losses), net   | (1,124)            | 75,534           |
| Amortization of losses into operating interest expense related to de-designated cash flow hedges deferred in accumulated other comprehensive loss, net | 188                | 3,256            |
| Net change from cash flow hedging instruments  | (936)              | 78,790           |
| Foreign currency translation gains (losses)  | (2,863)            | 1,909            |
| Other comprehensive income (loss)  | (8,078)            | 11,188           |
| Comprehensive income   | <u>\$161,332</u>   | <u>\$153,659</u> |

See accompanying notes to consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
(In thousands)  
(Unaudited)

|   | Shares Exchangeable<br>into Common Stock |        | Common Stock |          | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders'<br>Equity |
|---|--|--------|--------------|----------|----------------------------------|----------------------|---|----------------------------------|
|   | Shares                                   | Amount | Shares       | Amount   |                                  |                      |   |                                  |
| Balance, December 31, 2006  | —  | \$ —   | 426,304      | \$ 4,263 | \$ 3,184,290                     | \$ 1,209,289         | \$ (201,472)                                  | \$ 4,196,370                     |
| Net income  | —  | —      | —            | —        | —                                | 169,410              | —   | 169,410                          |
| Cumulative effect of adoption of FIN 48                                   | —  | —      | —            | —        | —                                | (14,903)             | —   | (14,903)                         |
| Other comprehensive loss  | —  | —      | —            | —        | —                                | —                    | (8,078)                                       | (8,078)                          |
| Exercise of stock options and purchase plans, including tax benefit       | —  | —      | 1,240        | 12       | 18,975                           | —                    | —   | 18,987                           |
| Repurchases of common stock   | —  | —      | (1,030)      | (10)     | (23,012)                         | —                    | —   | (23,022)                         |
| Issuance of restricted stock  | —  | —      | 615          | 6        | (6)                              | —                    | —   | —                                |
| Retirement of restricted stock to pay taxes                               | —  | —      | (64)         | (1)      | (1,518)                          | —                    | —   | (1,519)                          |
| Amortization of deferred stock compensation to APIC under SFAS No. 123(R) | —  | —      | —            | —        | 11,567                           | —                    | —   | 11,567                           |
| Other   | —  | —      | 97           | 2        | 2,212                            | —                    | —   | 2,214                            |
| Balance, March 31, 2007   | —  | \$ —   | 427,162      | \$ 4,272 | \$ 3,192,508                     | \$ 1,363,796         | \$ (209,550)                                  | \$ 4,351,026                     |

|   | Shares Exchangeable into<br>Common Stock |        | Common Stock |          | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders'<br>Equity |
|---|--|--------|--------------|----------|----------------------------------|----------------------|---|----------------------------------|
|   | Shares                                   | Amount | Shares       | Amount   |                                  |                      |   |                                  |
| Balance, December 31, 2005  | —  | \$ —   | 416,582      | \$ 4,166 | \$ 2,990,676                     | \$ 580,430           | \$ (175,712)                                  | \$ 3,399,560                     |
| Net income  | —  | —      | —            | —        | —                                | 142,471              | —   | 142,471                          |
| Other comprehensive income  | —  | —      | —            | —        | —                                | —                    | 11,188  | 11,188                           |
| Exercise of stock options and purchase plans, including tax benefit       | —  | —      | 1,379        | 14       | 20,195                           | —                    | —   | 20,209                           |
| Issuance of common stock upon conversion of 6% convertible debt           | —  | —      | 1,539        | 15       | 36,302                           | —                    | —   | 36,317                           |
| Issuance of restricted stock  | —  | —      | 539          | 5        | (5)                              | —                    | —   | —                                |
| Retirement of restricted stock to pay taxes                               | —  | —      | (3)          | (0)      | (77)                             | —                    | —   | (77)                             |
| Amortization of deferred stock compensation to APIC under SFAS No. 123(R) | —  | —      | —            | —        | 8,437                            | —                    | —   | 8,437                            |
| Other   | —  | —      | —            | —        | (84)                             | —                    | —   | (84)                             |
| Balance, March 31, 2006   | —  | \$ —   | 420,036      | \$ 4,200 | \$ 3,055,444                     | \$ 722,901           | \$ (164,524)                                  | \$ 3,618,021                     |

See accompanying notes to consolidated financial statements



**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
**(In thousands)**  
**(Unaudited)**

|   | Three Months Ended<br>March 31, |                     |
|---|---------------------------------|---------------------|
|   | 2007                            | 2006                |
| <b>Cash flows from operating activities:</b>  |                                 |                     |
| Net income  | \$ 169,410                      | \$ 142,471          |
| Adjustments to reconcile net income to net cash provided by operating activities:   |                                 |                     |
| Provision for loan losses   | 21,186                          | 10,197              |
| Depreciation and amortization (including discount amortization and accretion)   | 70,018                          | 72,605              |
| Gain on sales and impairment of investments, net  | (37,131)                        | (28,916)            |
| Equity in (income) loss of investments and venture funds  | (8,095)                         | 1,007               |
| Non-cash facility restructuring costs and other exit activities   | (850)                           | (1,155)             |
| Stock-based compensation  | 11,567                          | 8,437               |
| Tax benefit from tax deductions in excess of compensation expense   | (8,432)                         | (5,634)             |
| Other   | (28)                            | 2,581               |
| Net effect of changes in assets and liabilities:  |                                 |                     |
| Increase in cash and investments required to be segregated under Federal or other regulations                             | (128,944)                       | (485,885)           |
| Increase in margin receivables  | (125,168)                       | (1,221,671)         |
| Increase in customer payables   | 130,480                         | 1,489,724           |
| Proceeds from sales, repayments and maturities of loans held-for-sale   | 451,037                         | 379,687             |
| Purchases of loans held-for-sale  | (368,552)                       | (374,963)           |
| Proceeds from sales, repayments and maturities of trading securities  | 343,993                         | 170,644             |
| Purchases of trading securities   | (306,961)                       | (206,626)           |
| Other assets  | (400,590)                       | (351,459)           |
| Accounts payable, accrued and other liabilities   | 371,573                         | 498,451             |
| Facility restructuring liabilities  | (2,943)                         | (2,277)             |
| Net cash provided by operating activities   | <u>181,570</u>                  | <u>97,218</u>       |
| <b>Cash flows from investing activities:</b>  |                                 |                     |
| Purchases of available-for-sale mortgage-backed and investment securities   | (7,324,763)                     | (2,625,569)         |
| Proceeds from sales, maturities of and principal payments on available-for-sale mortgage-backed and investment securities | 4,823,918                       | 1,994,411           |
| Net increase in loans receivable  | (3,347,604)                     | (156,837)           |
| Purchases of property and equipment   | (43,427)                        | (21,252)            |
| Cash used in business acquisitions, net   | (2,688)                         | (11,646)            |
| Net cash flow from derivatives hedging assets   | 4,473                           | (59,531)            |
| Other   | (25,778)                        | 7,138               |
| Net cash used in investing activities   | <u>\$ (5,915,869)</u>           | <u>\$ (873,286)</u> |

See accompanying notes to consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS—(Continued)**  
**(In thousands)**  
**(Unaudited)**

|  | Three Months Ended  |                   |
|--|---------------------|-------------------|
|  | March 31,           |                   |
|  | 2007                | 2006              |
| <b>Cash flows from financing activities:</b>                                     |                     |                   |
| Net increase in deposits   | \$ 2,183,771        | \$ 3,285,769      |
| Advances from other long-term borrowings   | 3,386,000           | 95,100            |
| Payments on advances from other long-term borrowings                             | (2,229,934)         | (1,330,100)       |
| Net increase (decrease) in securities sold under agreements to repurchase        | 2,332,036           | (1,359,081)       |
| Net increase (decrease) in other borrowed funds                                  | 39,627              | (4,888)           |
| Proceeds from issuance of common stock from employee stock transactions          | 10,555              | 14,575            |
| Tax benefit from tax deductions in excess of compensation expense recognition    | 8,432               | 5,634             |
| Repurchases of common stock  | (23,022)            | —                 |
| Proceeds from issuance of subordinated debentures and trust preferred securities | 40,000              | 25,000            |
| Net cash flow from derivatives hedging liabilities                               | (30,419)            | 23,026            |
| Net cash provided by financing activities  | <u>5,717,046</u>    | <u>755,035</u>    |
| Decrease in cash and equivalents   | (17,253)            | (21,033)          |
| Cash and equivalents, beginning of period  | 1,212,234           | 844,188           |
| Cash and equivalents, end of period  | <u>\$ 1,194,981</u> | <u>\$ 823,155</u> |
| <b>Supplemental disclosures:</b>   |                     |                   |
| Cash paid for interest   | \$ 569,847          | \$ 291,102        |
| Cash paid for income taxes   | \$ 10,789           | \$ 3,060          |
| Non-cash investing and financing activities:                                     |                     |                   |
| Transfers from loans to other real estate owned and repossessed assets           | \$ 22,095           | \$ 14,356         |
| Reclassification of loans held-for-sale to loans held-for-investment             | \$ 8,973            | \$ 4,260          |
| Issuance of common stock to retire debentures                                    | \$ —                | \$ 36,317         |

See accompanying notes to consolidated financial statements

**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 1—ORGANIZATION, BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Organization**—E\*TRADE Financial Corporation (together with its subsidiaries, “E\*TRADE” or the “Company”) is a global company offering a wide range of financial services to consumers under the brand “E\*TRADE Financial.” The Company offers investing, trading, banking and lending products and services to its retail and institutional customers.

**Basis of Presentation**—The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. Entities in which the Company holds at least a 20% ownership or in which there are other indicators of significant influence are generally accounted for by the equity method. Entities in which the Company holds less than 20% ownership and does not have the ability to exercise significant influence are generally carried at cost. Intercompany accounts and transactions are eliminated in consolidation. The Company evaluates investments including joint ventures, low income housing tax credit partnerships and other limited partnerships to determine if the Company is required to consolidate the entities under the guidance of FASB interpretation No. 46, *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51* (“FIN 46R”).

Certain prior period items in these consolidated financial statements have been reclassified to conform to the current period presentation. As discussed in Note 2—Discontinued Operations, the operations of certain businesses have been accounted for as discontinued operations in accordance with the SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Accordingly, results of operations from prior periods have been reclassified to discontinued operations. Unless noted, discussions herein pertain to the Company’s continuing operations.

These consolidated financial statements reflect all adjustments, which are all normal and recurring in nature, necessary to present fairly the financial position, results of operations and cash flows for the periods presented, and should be read in conjunction with the consolidated financial statements of E\*TRADE Financial Corporation included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006.

The Company reports corporate interest income and expense separately from operating interest income and expense. The Company believes reporting these two items separately provides a clearer picture of the financial performance of the Company’s operations than would a presentation that combined these two items. Operating interest income and expense is generated from the operations of the Company and is a broad indicator of the Company’s success in its banking, lending and balance sheet management businesses. Corporate debt, which is the primary source of the corporate interest expense has been used primarily to finance acquisitions, such as *Harrisdirect* and *BrownCo* and generally has not been downstreamed to any of the Company’s operating subsidiaries.

Similarly, the Company reports gain on sales and impairment of investments separately from gain on sales of loans and securities, net. The Company believes reporting these two items separately provides a clearer picture of the financial performance of its operations than would a presentation that combined these two items. Gain on sales of loans and securities, net are the result of activities in the Company’s operations, namely its lending and balance sheet management businesses. Gain on sales and impairment of investments relates to historical equity investments of the Company at the corporate level and are not related to the ongoing business of the Company’s operating subsidiaries.

**New Income Statement Reporting Format**—During the period ended March, 31, 2007, the Company re-defined the line item “Service charges and fees” by reclassifying certain fee-like revenue items formerly reported in “Other revenue” into the “Service charges and fees” line item, now called “Fees and service charges.” The fee-like revenue streams moved include payment for order flow, foreign exchange margin revenue, 12b-1 fees after rebates, fixed income product revenues and management fee revenue.

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**New Balance Sheet Reporting Format**—During the period ended March 31, 2007, the Company re-presented its balance sheet to report margin receivables and customer payables directly on the face of the balance sheet. The remaining components of brokerage receivables and brokerage payables are now reported in the “Other assets” and “Accounts payable, accrued and other liabilities” line items, respectively.

**Use of Estimates**—The financial statements were prepared in accordance with GAAP, which require management to make estimates and assumptions that affect the amounts reported in the financial statements and related notes for the periods presented. Actual results could differ from management’s estimates. Material estimates in which management believes near-term changes could reasonably occur include allowance for loan losses and uncollectible margin receivables; classification and valuation of certain investments; valuation and accounting for financial derivatives; estimates of effective tax rates; deferred taxes and valuation allowances; valuation of goodwill and other intangibles; and valuation and expensing of share-based payments.

**Financial Statement Descriptions and Related Accounting Policies**—Below are descriptions and accounting policies for the Company’s new financial statement categories.

**Margin Receivables**—Margin receivables represent credit extended to customers and non-customers to finance their purchases of securities by borrowing against securities they currently own. Receivables from non-customers represent credit extended to principal officers and directors of the Company to finance their purchase of securities by borrowing against securities owned by them. Securities owned by customers and non-customers are held as collateral for amounts due on the margin receivables, the value of which is not reflected in the consolidated balance sheet. In many cases, the Company is permitted to sell or re-pledge these securities held as collateral and use the securities to enter into securities lending transactions, to collateralize borrowings or for delivery to counterparties to cover customer short positions. At March 31, 2007, the fair value of securities that the Company received as collateral in connection with margin receivables and stock borrowing activities, where the Company is permitted to sell or re-pledge the securities, was approximately \$9.8 billion. Of this amount, \$2.5 billion had been pledged or sold at March 31, 2007 in connection with securities loans, bank borrowings and deposits with clearing organizations.

**Customer Payables**—Customer payables to customers and non-customers represent credit balances in customer accounts arising from deposits of funds and sales of securities and other funds pending completion of securities transactions. The Company pays interest on certain customer payables balances.

**Fees and Service Charges**—Fees and service charges consist of account maintenance fees, servicing fee income, payments for order flow, foreign exchange margin revenue, 12b-1 fees after rebates, fixed income product revenues and management fee revenue. Account maintenance fees are charges to the customer either quarterly or annually and are accrued as earned. Payments for order flow are accrued in the same period in which the related securities transactions are completed or related services are rendered.

**Other Revenue**—Other revenue primarily consists of stock plan administration services and other revenue ancillary to the Company’s retail customer transactions. Stock plan administration services are recognized in accordance with applicable accounting guidance, including SOP 97-2, *Software Revenue Recognition*.

**New Accounting Standards**—Below are the new accounting pronouncements that relate to activities in which the Company is engaged.

*FIN No. 48—Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement 109*

In July 2006, the FASB issued Interpretation 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”), which became effective for the Company on January 1, 2007. The interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-

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likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The Company's reassessment of its tax positions in accordance with FIN 48 did not have a material impact on the results of operations, financial condition or liquidity. The impact of adoption was a \$14.9 million reduction to beginning retained earnings. For additional information regarding the adoption of FIN 48, see Note 12—Income Taxes.

### *SFAS No. 156—Accounting for Servicing of Financial Assets*

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, an amendment of SFAS No. 140. This statement establishes, among other things, the accounting for all separately recognized servicing assets and liabilities. This statement amends SFAS No. 140 to require that all separately recognized servicing assets and liabilities be initially measured at fair value. The Company adopted this statement on January 1, 2007 and the impact of adoption was not material to the Company's financial condition, results of operations or cash flows.

### *SFAS No. 157—Fair Value Measurements*

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement establishes, among other things, a framework for measuring fair value and expands disclosure requirements as they relate to fair value measurements. The statement is effective at the beginning of an entity's first fiscal year that begins after November 15, 2007 or January 1, 2008 for the Company. The Company is currently evaluating the impact this guidance will have on its financial condition, results of operations or cash flows.

### *SFAS No. 159—The Fair Value Option for Financial Assets and Financial Liabilities*

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement provides an option under which a company may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities. This fair value option will be available on a contract-by-contract basis with changes in fair value recognized in earnings as those changes occur. The statement is effective at the beginning of an entity's first fiscal year that begins after November 15, 2007 or January 1, 2008 for the Company. The Company is currently evaluating the impact this guidance will have on its financial condition, results of operations or cash flows.

## NOTE 2—DISCONTINUED OPERATIONS

### *E\*TRADE Professional Securities, LLC and E\*TRADE Professional Trading, LLC*

In May 2005, the Company closed E\*TRADE Professional Securities, LLC, a unit that conducted proprietary trading operations. In December 2005, the Company decided to sell its professional agency business, E\*TRADE Professional Trading, LLC. The Company executed and settled this transaction during the year ended December 31, 2006 and recorded approximately \$2.6 million in gain, net of tax, on the sale.

The following table summarizes the results of discontinued operations for the proprietary and agency trading businesses (dollars in thousands):

|   | Three Months Ended |          |
|---|--------------------|----------|
|   | March 31,          |          |
|   | 2007               | 2006     |
| Net revenue                                   | \$ —               | \$ 2,701 |
| Loss from discontinued operations             | \$ —               | \$ (840) |
| Income tax benefit                            | —                  | (327)    |
| Loss from discontinued operations, net of tax | \$ —               | \$ (513) |

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**NOTE 3—FACILITY RESTRUCTURING AND OTHER EXIT ACTIVITIES**

The Company periodically evaluates and adjusts its estimated costs associated with its restructuring plans and other exit activities. Restructuring liabilities are included in accounts payable, accrued and other liabilities in the consolidated balance sheet. The following table summarizes the amount recognized by the Company as facility restructuring and other exit activities for the periods presented (dollars in thousands):

|  | Three Months Ended<br>March 31, |                 |
|--|---------------------------------|-----------------|
|  | 2007                            | 2006            |
| 2003 Restructuring Plan                                | \$ —                            | \$ (258)        |
| 2001 Restructuring Plan                                | (482)                           | (715)           |
| Other exit activities                                  | 1,215                           | 720             |
| Total facility restructuring and other exit activities | <u>\$ 733</u>                   | <u>\$ (253)</u> |

**2003 Restructuring Plan**

In April 2003, the Company announced a restructuring plan (“2003 Restructuring Plan”) exiting and consolidating leased facilities and exiting and disposing of certain unprofitable product offerings and initiatives. Facility consolidation costs are expected to be paid over contractual periods ending in fiscal year 2010. The roll forward of the 2003 Restructuring Plan reserve is presented below (dollars in thousands):

|  | Facility<br>Consolidation | Other       | Total            |
|--|---------------------------|-------------|------------------|
| Total 2003 Restructuring Reserve, originally recorded in 2003: |                           |             |                  |
| Facility restructuring and other exit activities recorded      | \$ 58,547                 | \$ 57,319   | \$115,866        |
| Cash payments  | (26,371)                  | (18,949)    | (45,320)         |
| Non-cash charges   | (19,254)                  | (38,370)    | (57,624)         |
| Restructuring liabilities at December 31, 2006                 | 12,922                    | —           | 12,922           |
| Activity for the three months ended March 31, 2007:            |                           |             |                  |
| Cash payments  | (1,256)                   | —           | (1,256)          |
| Total facility restructuring liabilities at March 31, 2007     | <u>\$ 11,666</u>          | <u>\$ —</u> | <u>\$ 11,666</u> |

**2001 Restructuring Plan**

In August 2001, the Company announced a restructuring plan (“2001 Restructuring Plan”) aimed at streamlining operations primarily by consolidating facilities in the United States and Europe. Facility consolidation costs are expected to be paid over contractual periods ending in fiscal year 2010. The roll forward of the 2001 Restructuring Plan reserve is presented below (dollars in thousands):

|  | Facility<br>Consolidation | Asset<br>Write-Off | Other       | Total           |
|--|---------------------------|--------------------|-------------|-----------------|
| Total 2001 Restructuring Reserve, originally recorded in 2001:                       |                           |                    |             |                 |
| Facility restructuring and other exit activities recorded                            | \$ 149,684                | \$ 54,384          | \$ 26,401   | \$ 230,469      |
| Cash payments  | (103,728)                 | (507)              | (20,507)    | (124,742)       |
| Non-cash charges   | (41,263)                  | (53,877)           | (5,810)     | (100,950)       |
| Restructuring liabilities at December 31, 2006                                       | 4,693                     | —                  | 84          | 4,777           |
| Activity for the three months ended March 31, 2007:                                  |                           |                    |             |                 |
| Adjustments and additional charges   | (398)                     | —                  | (84)        | (482)           |
| Cash payments  | (503)                     | —                  | —           | (503)           |
| Total facility restructuring and other exit activities liabilities at March 31, 2007 | <u>\$ 3,792</u>           | <u>\$ —</u>        | <u>\$ —</u> | <u>\$ 3,792</u> |

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Toward the end of the second quarter of 2006, the Company decided to relocate certain functions out of the state of California as well as outsource certain clearing operations and costs related to the relocation of certain accounting functions. The Company incurred costs of \$1.2 million for the three months ended March 31, 2007 related to costs for exiting those facilities. The total charge for this exit activity was \$30.4 million, all of which has been recorded in the retail segment. The Company expects to incur charges in future periods as it periodically evaluates the estimates made in connection with this activity; however, the Company does not expect those costs to be significant.

**NOTE 4—OPERATING INTEREST INCOME AND OPERATING INTEREST EXPENSE**

The following table shows the components of operating interest income and operating interest expense (dollars in thousands):

|   | Three Months Ended |                   |
|---|--------------------|-------------------|
|   | March 31,          |                   |
|   | 2007               | 2006              |
| Operating interest income:                |                    |                   |
| Loans, net                                | \$ 451,399         | \$ 281,270        |
| Mortgage-backed and investment securities | 214,143            | 159,501           |
| Margin receivables                        | 123,986            | 104,904           |
| Other                                     | 40,267             | 48,619            |
| Total operating interest income           | <u>829,795</u>     | <u>594,294</u>    |
| Operating interest expense:               |                    |                   |
| Deposits                                  | (182,988)          | (94,618)          |
| Other borrowings                          | (256,221)          | (174,887)         |
| Total operating interest expense          | <u>(439,209)</u>   | <u>(269,505)</u>  |
| Net operating interest income             | <u>\$ 390,586</u>  | <u>\$ 324,789</u> |

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**NOTE 5—AVAILABLE-FOR-SALE MORTGAGE-BACKED AND INVESTMENT SECURITIES**

The amortized cost basis and estimated fair values of available-for-sale mortgage-backed and investment securities are shown in the following tables (dollars in thousands):

|  | Amortized<br>Cost   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Values |
|--|---------------------|------------------------------|-------------------------------|--------------------------|
| <b>March 31, 2007:</b>                                   |                     |                              |                               |                          |
| Mortgage-backed securities:                              |                     |                              |                               |                          |
| Backed by U.S. Government sponsored and Federal agencies | \$10,670,579        | \$ —                         | \$(293,101)                   | \$ 10,377,478            |
| Collateralized mortgage obligations and other            | 1,848,216           | 908                          | (18,208)                      | 1,830,916                |
| Total mortgage-backed securities                         | <u>12,518,795</u>   | <u>908</u>                   | <u>(311,309)</u>              | <u>12,208,394</u>        |
| Investment securities:                                   |                     |                              |                               |                          |
| Debt securities:   |                     |                              |                               |                          |
| Asset-backed securities                                  | 2,629,161           | 6,945                        | (28,103)                      | 2,608,003                |
| Municipal bonds  | 746,041             | 12,095                       | (696)                         | 757,440                  |
| Corporate bonds  | 93,286              | 518                          | (1,396)                       | 92,408                   |
| Other debt securities                                    | 79,761              | —                            | (5,300)                       | 74,461                   |
| Total debt securities                                    | <u>3,548,249</u>    | <u>19,558</u>                | <u>(35,495)</u>               | <u>3,532,312</u>         |
| Publicly traded equity securities:                       |                     |                              |                               |                          |
| Preferred stock  | 377,933             | 4,519                        | (2,216)                       | 380,236                  |
| Corporate investments                                    | 17,737              | 19,960                       | (182)                         | 37,515                   |
| FHLB stock   | 296,170             | —                            | —                             | 296,170                  |
| Retained interests from securitizations                  | 2,950               | 904                          | —                             | 3,854                    |
| Total investment securities                              | <u>4,243,039</u>    | <u>44,941</u>                | <u>(37,893)</u>               | <u>4,250,087</u>         |
| Total available-for-sale securities                      | <u>\$16,761,834</u> | <u>\$ 45,849</u>             | <u>\$(349,202)</u>            | <u>\$ 16,458,481</u>     |
| <b>December 31, 2006:</b>                                |                     |                              |                               |                          |
| Mortgage-backed securities:                              |                     |                              |                               |                          |
| Backed by U.S. Government sponsored and Federal agencies | \$ 9,375,444        | \$ 688                       | \$(266,825)                   | \$ 9,109,307             |
| Collateralized mortgage obligations and other            | 1,127,650           | 296                          | (19,561)                      | 1,108,385                |
| Total mortgage-backed securities                         | <u>10,503,094</u>   | <u>984</u>                   | <u>(286,386)</u>              | <u>10,217,692</u>        |
| Investment securities:                                   |                     |                              |                               |                          |
| Debt securities:   |                     |                              |                               |                          |
| Asset-backed securities                                  | 2,163,538           | 9,929                        | (11,739)                      | 2,161,728                |
| Municipal bonds  | 620,261             | 13,316                       | (830)                         | 632,747                  |
| Corporate bonds  | 105,692             | 481                          | (1,655)                       | 104,518                  |
| Other debt securities                                    | 80,623              | —                            | (5,743)                       | 74,880                   |
| Total debt securities                                    | <u>2,970,114</u>    | <u>23,726</u>                | <u>(19,967)</u>               | <u>2,973,873</u>         |
| Publicly traded equity securities:                       |                     |                              |                               |                          |
| Preferred stock  | 455,801             | 4,905                        | (2,032)                       | 458,674                  |
| Corporate investments                                    | 12,040              | 13,691                       | (1,592)                       | 24,139                   |
| FHLB stock   | 244,212             | —                            | —                             | 244,212                  |
| Retained interests from securitizations                  | 2,930               | 463                          | —                             | 3,393                    |
| Total investment securities                              | <u>3,685,097</u>    | <u>42,785</u>                | <u>(23,591)</u>               | <u>3,704,291</u>         |
| Total available-for-sale securities                      | <u>\$14,188,191</u> | <u>\$ 43,769</u>             | <u>\$(309,977)</u>            | <u>\$ 13,921,983</u>     |



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**Other-Than-Temporary Impairment of Investments**

The following tables show the fair values and unrealized losses on investments, aggregated by investment category, and the length of time that individual securities have been in a continuous unrealized loss position (dollars in thousands):

|  | Less than 12 Months |                   | 12 Months or More  |                    | Total               |                    |
|--|---------------------|-------------------|--------------------|--------------------|---------------------|--------------------|
|  | Fair Values         | Unrealized Losses | Fair Values        | Unrealized Losses  | Fair Values         | Unrealized Losses  |
| <b>March 31, 2007:</b>                                   |                     |                   |                    |                    |                     |                    |
| Mortgage-backed securities:                              |                     |                   |                    |                    |                     |                    |
| Backed by U.S. Government sponsored and Federal agencies | \$2,730,526         | \$(42,184)        | \$7,646,026        | \$(250,917)        | \$10,376,552        | \$(293,101)        |
| Collateralized mortgage obligations and other            | 572,895             | (1,665)           | 746,757            | (16,543)           | 1,319,652           | (18,208)           |
| Debt securities:   |                     |                   |                    |                    |                     |                    |
| Asset-backed securities                                  | 813,852             | (18,500)          | 719,204            | (9,603)            | 1,533,056           | (28,103)           |
| Municipal bonds  | 121,886             | (696)             | —                  | —                  | 121,886             | (696)              |
| Corporate bonds  | —                   | —                 | 61,042             | (1,396)            | 61,042              | (1,396)            |
| Other debt securities                                    | 1,391               | (8)               | 73,073             | (5,292)            | 74,464              | (5,300)            |
| Publicly traded equity securities:                       |                     |                   |                    |                    |                     |                    |
| Preferred stock  | 201,173             | (1,413)           | 20,685             | (803)              | 221,858             | (2,216)            |
| Corporate investments                                    | —                   | —                 | 180                | (182)              | 180                 | (182)              |
| Total temporarily impaired securities                    | <u>\$4,441,723</u>  | <u>\$(64,466)</u> | <u>\$9,266,967</u> | <u>\$(284,736)</u> | <u>\$13,708,690</u> | <u>\$(349,202)</u> |
| <b>December 31, 2006:</b>                                |                     |                   |                    |                    |                     |                    |
| Mortgage-backed securities:                              |                     |                   |                    |                    |                     |                    |
| Backed by U.S. Government sponsored and Federal agencies | \$1,482,684         | \$(38,671)        | \$7,551,572        | \$(228,154)        | \$ 9,034,256        | \$(266,825)        |
| Collateralized mortgage obligations and other            | 399,779             | (2,258)           | 640,811            | (17,303)           | 1,040,590           | (19,561)           |
| Debt securities:   |                     |                   |                    |                    |                     |                    |
| Asset-backed securities                                  | 358,628             | (2,520)           | 629,889            | (9,219)            | 988,517             | (11,739)           |
| Municipal bonds  | 58,548              | (467)             | 28,326             | (363)              | 86,874              | (830)              |
| Corporate bonds  | 765                 | (23)              | 72,661             | (1,632)            | 73,426              | (1,655)            |
| Other debt securities                                    | —                   | —                 | 72,750             | (5,743)            | 72,750              | (5,743)            |
| Publicly traded equity securities:                       |                     |                   |                    |                    |                     |                    |
| Preferred stock  | 37,663              | (420)             | 25,971             | (1,612)            | 63,634              | (2,032)            |
| Corporate investments                                    | 8,486               | (1,386)           | 156                | (206)              | 8,642               | (1,592)            |
| Total temporarily impaired securities                    | <u>\$2,346,553</u>  | <u>\$(45,745)</u> | <u>\$9,022,136</u> | <u>\$(264,232)</u> | <u>\$11,368,689</u> | <u>\$(309,977)</u> |

The Company does not believe that any individual unrealized loss as of March 31, 2007 represents an other-than-temporary impairment. The majority of the unrealized losses on mortgage- and asset-backed securities are attributable to changes in interest rates and are not reflective of deterioration in the credit quality of the issuer and/or securitization. Substantially all mortgage-backed securities backed by U.S. Government sponsored and Federal agencies are "AAA" rated and have unrealized losses due to changes in market interest rates. As market interest rates increase, the fair value of fixed-rate securities will decrease. The Company has the intent and ability to hold these securities until the market value recovers or the securities mature. Municipal bonds, corporate bonds and other debt securities are evaluated by reviewing the credit-worthiness of the lender and general market conditions. Based on its evaluation, the Company recorded other-than-temporary impairment charges of \$0.2 million for its asset-backed securities and \$0.4 million for its retained beneficial interest in securitized receivables held by a subsidiary, ETCF Asset Funding Corporation, for the three months ended March 31, 2007 and 2006, respectively.

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**Gain on Sales of Loans and Securities, Net**

Gain on sales of loans and securities, net are as follows (dollars in thousands):

|   | Three Months Ended |                 |
|---|--------------------|-----------------|
|   | March 31,          |                 |
|   | 2007               | 2006            |
| Gain on sales of originated loans               | \$ 1,915           | \$ 3,318        |
| Loss on sales of loans held-for-sale, net       | (1,662)            | (689)           |
| Gain on sales of securities, net <sup>(1)</sup> | 17,122             | 8,999           |
| Gain on sales of loans and securities, net      | <u>\$17,375</u>    | <u>\$11,628</u> |

<sup>(1)</sup> Includes an other-than-temporary charge of \$0.2 million for impairment on asset-backed securities for the quarter ending March 31, 2007. There was no such charge for the quarter ended March 31, 2006.

**Gain on Sales and Impairment of Investments**

Gain on sales and impairment of investments are as follows (dollars in thousands):

|  | Three Months Ended |                 |
|--|--------------------|-----------------|
|  | March 31,          |                 |
|  | 2007               | 2006            |
| Realized gains on sales of publicly traded equity securities           | \$19,717           | \$18,055        |
| Realized losses on sales of investments and impairments                | —                  | (455)           |
| Gains (losses) on sales of other equity securities, net <sup>(1)</sup> | 39                 | 16              |
| Gain on sales and impairment of investments                            | <u>\$19,756</u>    | <u>\$17,616</u> |

<sup>(1)</sup> Includes an other-than-temporary charge of \$0.4 million for impairment on retained interests from securitizations for the quarter ending March 31, 2006. There was no such charge for the quarter ended March 31, 2007.

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Loans, net are summarized as follows (dollars in thousands):

|                                | March 31,<br>2007   | December 31,<br>2006 |
|--------------------------------|---------------------|----------------------|
| Loans held-for-sale            | \$ 193,385          | \$ 283,496           |
| Loans receivable, net:         |                     |                      |
| Real estate loans:             |                     |                      |
| One- to four-family            | 13,360,842          | 10,870,214           |
| HELOC, HEIL and other          | 12,759,680          | 11,809,008           |
| Total real estate loans        | <u>26,120,522</u>   | <u>22,679,222</u>    |
| Consumer and other loans:      |                     |                      |
| Recreational vehicle           | 2,182,334           | 2,292,356            |
| Marine                         | 621,368             | 651,764              |
| Commercial                     | 233,301             | 219,008              |
| Credit card                    | 109,559             | 128,583              |
| Automobile                     | 56,849              | 77,533               |
| Other                          | 2,940               | 3,706                |
| Total consumer and other loans | <u>3,206,351</u>    | <u>3,372,950</u>     |
| Total loans receivable         | <u>29,326,873</u>   | <u>26,052,172</u>    |
| Unamortized premiums, net      | 412,758             | 388,153              |
| Allowance for loan losses      | <u>(67,989)</u>     | <u>(67,628)</u>      |
| Total loans receivable, net    | <u>29,671,642</u>   | <u>26,372,697</u>    |
| Total loans, net               | <u>\$29,865,027</u> | <u>\$26,656,193</u>  |

During the first quarter of 2007, the Company entered into a credit default swap (“CDS”) on \$4.0 billion of its first-lien residential mortgage loan portfolio. A CDS provides, for a fee, an assumption by a third party of a portion of the credit risk related to the underlying loans. The CDS the Company entered into provides protection for losses in excess of 10 basis points, but not to exceed approximately 75 basis points. In addition, the Company’s regulatory risk-weighted assets were reduced as a result of this transaction because it transferred a portion of the Company’s credit risk to an unaffiliated third party.

**NOTE 7—ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES**

The Company enters into derivative transactions to protect against the risk of market price or interest rate movements on the value of certain assets, liabilities and future cash flows. The Company is also required to recognize certain contracts and commitments as derivatives when the characteristics of those contracts and commitments meet the definition of a derivative as promulgated by SFAS No. 133, as amended.

***Fair Value Hedges******Overview of Fair Value Hedges***

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on swaps, interest rate caps and interest rate floors to offset its exposure to changes in value of certain fixed-rate assets and liabilities. Changes in the fair value of the derivatives are recognized currently in earnings. Hedge ineffectiveness, if any, is recognized currently in other expense excluding interest in the consolidated statement of income.

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The following table summarizes information related to financial derivatives in fair value hedge relationships (dollars in thousands):

|  | Notional<br>Amount of<br>Derivatives | Fair Value of Derivatives |                   |                  | Weighted-Average |                 |                |                           |
|--|--------------------------------------|---------------------------|-------------------|------------------|------------------|-----------------|----------------|---------------------------|
|  |                                      | Asset                     | Liability         | Net              | Pay<br>Rate      | Receive<br>Rate | Strike<br>Rate | Remaining<br>Life (Years) |
| <b>March 31, 2007:</b>                           |                                      |                           |                   |                  |                  |                 |                |                           |
| Pay-fixed interest rate swaps:                   |                                      |                           |                   |                  |                  |                 |                |                           |
| Mortgage-backed securities                       | \$ 3,612,000                         | \$ 6,636                  | \$(23,655)        | \$(17,019)       | 5.12%            | 5.35%           | N/A            | 5.16                      |
| Recreational vehicle loans                       | 396,000                              | 614                       | —                 | 614              | 5.09%            | 5.35%           | N/A            | 3.30                      |
| Home equity loans                                | 330,000                              | 319                       | (1,254)           | (935)            | 5.12%            | 5.34%           | N/A            | 3.35                      |
| Receive-fixed interest rate swaps:               |                                      |                           |                   |                  |                  |                 |                |                           |
| Brokered certificates of deposit                 | 125,995                              | —                         | (2,796)           | (2,796)          | 5.30%            | 5.21%           | N/A            | 11.15                     |
| FHLB advances                                    | 100,000                              | —                         | (2,876)           | (2,876)          | 5.32%            | 3.64%           | N/A            | 2.55                      |
| Purchased interest rate forward-starting swaps:  |                                      |                           |                   |                  |                  |                 |                |                           |
| Mortgage-backed securities                       | 50,000                               | 43                        | —                 | 43               | 4.98%            | N/A             | N/A            | 5.01                      |
| Purchased interest rate options <sup>(1)</sup> : |                                      |                           |                   |                  |                  |                 |                |                           |
| Caps   | 3,315,000                            | 22,160                    | —                 | 22,160           | N/A              | N/A             | 5.34%          | 2.42                      |
| Swaptions <sup>(2)</sup>                         | 2,843,000                            | 58,541                    | —                 | 58,541           | N/A              | N/A             | 5.38%          | 10.65                     |
| Floors   | 1,200,000                            | 17,033                    | —                 | 17,033           | N/A              | N/A             | 4.74%          | 4.56                      |
| Total fair value hedges                          | <u>\$11,971,995</u>                  | <u>\$105,346</u>          | <u>\$(30,581)</u> | <u>\$ 74,765</u> | 5.13%            | 5.31%           | 5.26%          | 5.57                      |
| <b>December 31, 2006:</b>                        |                                      |                           |                   |                  |                  |                 |                |                           |
| Pay-fixed interest rate swaps:                   |                                      |                           |                   |                  |                  |                 |                |                           |
| Mortgage-backed securities                       | \$ 4,774,000                         | \$ 22,399                 | \$(25,894)        | \$(3,495)        | 5.12%            | 5.36%           | N/A            | 4.20                      |
| Recreational vehicle loans                       | 2,030,000                            | —                         | (8,046)           | (8,046)          | 5.46%            | 5.35%           | N/A            | 1.62                      |
| Home equity loans                                | 490,000                              | —                         | (2,625)           | (2,625)          | 5.40%            | 5.35%           | N/A            | 2.16                      |
| Investment securities                            | 335,162                              | 1,128                     | (2,887)           | (1,759)          | 5.07%            | 5.37%           | N/A            | 6.69                      |
| Asset backed securities                          | 232,000                              | 1,013                     | —                 | 1,013            | 5.08%            | 5.37%           | N/A            | 6.52                      |
| Receive-fixed interest rate swaps:               |                                      |                           |                   |                  |                  |                 |                |                           |
| Brokered certificates of deposit                 | 127,138                              | —                         | (3,392)           | (3,392)          | 5.31%            | 5.21%           | N/A            | 11.41                     |
| FHLB advances                                    | 100,000                              | —                         | (3,534)           | (3,534)          | 5.35%            | 3.64%           | N/A            | 2.79                      |
| Purchased interest rate options <sup>(1)</sup> : |                                      |                           |                   |                  |                  |                 |                |                           |
| Caps   | 6,720,000                            | 38,237                    | —                 | 38,237           | N/A              | N/A             | 5.36%          | 2.18                      |
| Swaptions <sup>(2)</sup>                         | 3,338,000                            | 50,218                    | —                 | 50,218           | N/A              | N/A             | 5.37%          | 10.69                     |
| Floors   | 1,200,000                            | 19,786                    | —                 | 19,786           | N/A              | N/A             | 4.74%          | 4.81                      |
| Total fair value hedges                          | <u>\$19,346,300</u>                  | <u>\$132,781</u>          | <u>\$(46,378)</u> | <u>\$ 86,403</u> | 5.22%            | 5.34%           | 5.30%          | 4.44                      |

(1) Purchased interest rate options were used to hedge mortgage loans and mortgage-backed securities.

(2) Swaptions are options to enter swaps starting on a given day.

**De-designated Fair Value Hedges**

During the three months ended March 31, 2007 and 2006, certain fair value hedges were de-designated; therefore, hedge accounting was discontinued during those periods. The net gain or loss on the underlying transactions being hedged is amortized to operating interest expense or operating interest income over the original forecasted period at the time of de-designation. Changes in the fair value of these derivative instruments after de-designation of fair value hedge accounting were recorded in the gain on sales of loans and securities, net line item in the consolidated statement of income.

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**Cash Flow Hedges**

*Overview of Cash Flow Hedges*

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on caps and floors to hedge the variability of future cash flows associated with existing variable-rate liabilities and assets and forecasted issuances of liabilities. These cash flow hedge relationships are treated as effective hedges as long as the future issuances of liabilities remain probable and the hedges continue to meet the requirements of SFAS No. 133, as amended. The Company also enters into interest rate swaps to hedge changes in the future variability of cash flows of certain investment securities resulting from changes in a benchmark interest rate. Additionally, the Company enters into forward purchase and sale agreements, which are considered cash flow hedges, when the terms of the commitments exactly match the terms of the securities purchased or sold.

Changes in the fair value of derivatives that hedge cash flows associated with repurchase agreements, FHLB advances and HELOC are reported in accumulated other comprehensive loss as unrealized gains or losses. The amounts in accumulated other comprehensive loss are then included in operating interest expense or operating interest income as a yield adjustment during the same periods in which the related interest on the funding effects earnings. During the upcoming twelve months, the Company expects to include a pre-tax amount of approximately \$27.1 million of net unrealized gains that are currently reflected in accumulated other comprehensive loss in operating interest expense as a yield adjustment in the same periods in which the related items affect earnings.

The following table summarizes information related to the Company's financial derivatives in cash flow hedge relationships, hedging variable-rate assets and liabilities and the forecasted issuances of liabilities (dollars in thousands):

|  | Notional Amount of Derivatives | Fair Value of Derivatives |                   |                  | Weighted-Average |              |             |                        |
|--|--------------------------------|---------------------------|-------------------|------------------|------------------|--------------|-------------|------------------------|
|  |                                | Asset                     | Liability         | Net              | Pay Rate         | Receive Rate | Strike Rate | Remaining Life (Years) |
| <b>March 31, 2007:</b>                           |                                |                           |                   |                  |                  |              |             |                        |
| Pay-fixed interest rate swaps:                   |                                |                           |                   |                  |                  |              |             |                        |
| Repurchase agreements                            | \$ 3,335,000                   | \$ 5,364                  | \$(21,484)        | \$(16,120)       | 5.37%            | 5.34%        | N/A         | 5.72                   |
| FHLB advances                                    | 850,000                        | 3,839                     | (3,860)           | (21)             | 5.16%            | 5.36%        | N/A         | 9.27                   |
| Purchase interest rate forward-starting swaps:   |                                |                           |                   |                  |                  |              |             |                        |
| Repurchase agreements                            | 200,000                        | 843                       | —                 | 843              | 5.12%            | N/A          | N/A         | 10.09                  |
| FHLB advances                                    | 250,000                        | 545                       | —                 | 545              | 5.13%            | N/A          | N/A         | 10.13                  |
| Purchased interest rate options <sup>(1)</sup> : |                                |                           |                   |                  |                  |              |             |                        |
| Caps   | 4,975,000                      | 82,747                    | —                 | 82,747           | N/A              | N/A          | 5.16%       | 4.72                   |
| Floors   | 1,900,000                      | 616                       | —                 | 616              | N/A              | N/A          | 4.05%       | 1.84                   |
| Total cash flow hedges                           | <u>\$11,510,000</u>            | <u>\$93,954</u>           | <u>\$(25,344)</u> | <u>\$ 68,610</u> | 5.30%            | 5.34%        | 4.85%       | 5.08                   |
| <b>December 31, 2006:</b>                        |                                |                           |                   |                  |                  |              |             |                        |
| Pay-fixed interest rate swaps:                   |                                |                           |                   |                  |                  |              |             |                        |
| Repurchase agreements                            | \$ 3,435,000                   | \$ 7,683                  | \$(21,823)        | \$(14,140)       | 5.36%            | 5.36%        | N/A         | 5.90                   |
| FHLB advances                                    | 730,000                        | 3,671                     | (3,301)           | 370              | 5.16%            | 5.37%        | N/A         | 8.56                   |
| Purchased interest rate options <sup>(1)</sup> : |                                |                           |                   |                  |                  |              |             |                        |
| Caps   | 4,690,000                      | 62,710                    | —                 | 62,710           | N/A              | N/A          | 5.05%       | 3.36                   |
| Floors   | 1,900,000                      | 643                       | —                 | 643              | N/A              | N/A          | 4.05%       | 2.09                   |
| Total cash flow hedges                           | <u>\$10,755,000</u>            | <u>\$74,707</u>           | <u>\$(25,124)</u> | <u>\$ 49,583</u> | 5.33%            | 5.36%        | 4.76%       | 4.30                   |

<sup>(1)</sup> Caps are used to hedge repurchase agreements and FHLB advances. Floors are used to hedge HELOC.

Under SFAS No. 133, as amended, the Company is required to record the fair value of gains and losses on derivatives designated as cash flow hedges in accumulated other comprehensive income in the consolidated balance sheet. In addition, during the normal course of business, the Company terminates certain interest rate swaps and options.

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The following tables show: 1) amounts recorded in accumulated other comprehensive loss related to derivative instruments accounted for as cash flow hedges; 2) the notional amounts and fair values of derivatives terminated for the periods presented; and 3) the amortization of terminated interest rate swaps included in operating interest expense and operating interest income (dollars in thousands):

|   | Three Months Ended<br>March 31, |                 |
|---|---------------------------------|-----------------|
|   | 2007                            | 2006            |
| Impact on accumulated other comprehensive loss (net of taxes):  |                                 |                 |
| Beginning balance   | \$ (27,844)                     | \$ (70,831)     |
| Gains (losses) on cash flow hedges related to derivatives, net  | (1,124)                         | 75,534          |
| Reclassifications into earnings, net  | 188                             | 3,256           |
| Ending balance  | <u>\$ (28,780)</u>              | <u>\$ 7,959</u> |
| Derivatives terminated during the period:   |                                 |                 |
| Notional  | \$690,000                       | \$3,260,000     |
| Fair value of net gains (losses) recognized in accumulated other comprehensive loss   | \$ (2,377)                      | \$ 33,546       |
| Amortization of terminated interest rate swaps and options included in operating interest expense and operating interest income | \$ 308                          | \$ 5,122        |

The gains (losses) accumulated in other comprehensive loss on the derivative instruments terminated shown in the preceding table will be included in operating interest expense and operating interest income over the periods the variable rate liabilities and hedged forecasted issuance of liabilities will affect earnings, ranging from 18 days to more than 14 years.

The following table shows the balance in accumulated other comprehensive loss attributable to open cash flow hedges and discontinued cash flow hedges (dollars in thousands):

|   | Three Months Ended<br>March 31, |                 |
|---|---------------------------------|-----------------|
|   | 2007                            | 2006            |
| Accumulated other comprehensive loss balance (net of taxes) related to: |                                 |                 |
| Open cash flow hedges   | \$ (49,820)                     | \$ 17,934       |
| Discontinued cash flow hedges   | 21,040                          | (9,975)         |
| Total cash flow hedges  | <u>\$ (28,780)</u>              | <u>\$ 7,959</u> |

### Hedge Ineffectiveness

In accordance with SFAS No. 133, as amended, the Company recognizes hedge ineffectiveness on both fair value and cash flow hedge relationships. The amount of ineffectiveness recorded in earnings for cash flow hedges is equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of a hypothetical derivative which is created to match the exact terms of the underlying instruments being hedged. These amounts are reflected in the other expense excluding interest line item in the consolidated statement of income. Cash flow and fair value ineffectiveness is re-measured on a quarterly basis. The following table summarizes income (expense) recognized by the Company as fair value and cash flow hedge ineffectiveness (dollars in thousands):

|                             | Three Months Ended<br>March 31, |                   |
|-----------------------------|---------------------------------|-------------------|
|                             | 2007                            | 2006              |
| Fair value hedges           | \$ (1,082)                      | \$ (1,945)        |
| Cash flow hedges            | 40                              | (24)              |
| Total hedge ineffectiveness | <u>\$ (1,042)</u>               | <u>\$ (1,969)</u> |

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[Table of Contents](#)**Mortgage Banking Activities**

The Company enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding. These commitments are referred to as Interest Rate Lock Commitments (“IRLCs”). IRLCs on loans that the Company intends to sell are considered to be derivatives and are, therefore, recorded at fair value with changes in fair value recorded in earnings. For purposes of determining fair value, the Company performs a net present value analysis of the anticipated cash flows associated with these IRLCs. The net present value analysis performed excludes the market value associated with the anticipated sale of servicing rights related to each loan commitment. The fair value of these IRLCs was a \$0.3 million and \$0.02 million liability at March 31, 2007 and December 31, 2006, respectively.

The Company also designates fair value relationships of closed loans held-for-sale against a combination of mortgage forwards and short treasury positions. Short treasury relationships are economic hedges, rather than fair value or cash flow hedges. Short treasury positions are marked-to-market, but do not receive hedge accounting treatment under SFAS No. 133, as amended. The mark-to-market of the mortgage forwards is included in the net change of the IRLCs and the related hedging instruments. The fair value of the mark-to-market on closed loans was a \$0.8 million and \$1.7 million asset at March 31, 2007 and December 31, 2006, respectively.

IRLCs, as well as closed loans held-for-sale, expose the Company to interest rate risk. The Company manages this risk by selling mortgages or mortgage-backed securities on a forward basis referred to as forward sale agreements. Changes in the fair value of these derivatives are included as gain on sales of loans and securities, net in the consolidated statement of income. The net change in IRLCs, closed loans, mortgage forwards and the short treasury positions generated a net loss of \$1.6 million and \$0.2 million for the three months ended March 31, 2007 and 2006, respectively.

**NOTE 8—OTHER ASSETS**

Other assets consist of the following (dollars in thousands):

|  | March 31,<br>2007   | December 31,<br>2006 |
|--|---------------------|----------------------|
| Deposits paid for securities borrowed                              | \$ 531,637          | \$ 448,047           |
| Accrued interest receivable  | 297,522             | 182,265              |
| Third party loan servicing receivable                              | 267,784             | 241,511              |
| Derivative assets  | 209,548             | 208,136              |
| Net settlement and deposits with clearing organizations            | 177,238             | 137,571              |
| Other receivables from brokers, dealers and clearing organizations | 173,098             | 72,596               |
| Other investments  | 150,432             | 138,006              |
| Fails to deliver   | 119,137             | 86,517               |
| Prepays  | 43,363              | 41,216               |
| Unamortized debt issue costs                                       | 24,437              | 26,498               |
| Deferred compensation plan   | 20,631              | 20,584               |
| Servicing rights   | 8,143               | 8,487                |
| Other  | 196,223             | 185,547              |
| Total other assets   | <u>\$ 2,219,193</u> | <u>\$ 1,796,981</u>  |

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**NOTE 9—DEPOSITS**

Deposits are summarized as follows (dollars in thousands):

|   | Weighted-Average Rate  |                   | Amount              |                     | Percentage to Total |                   |
|---|------------------------|-------------------|---------------------|---------------------|---------------------|-------------------|
|   | March 31, 2007         | December 31, 2006 | March 31, 2007      | December 31, 2006   | March 31, 2007      | December 31, 2006 |
|   | Sweep deposit accounts | 0.92%             | 0.94%               | \$10,803,331        | \$10,837,124        | 41.1%             |
| Money market and savings accounts               | 4.38%                  | 4.33%             | 9,879,772           | 7,634,241           | 37.6                | 31.7              |
| Certificates of deposit <sup>(1)</sup>          | 5.03%                  | 5.02%             | 4,738,123           | 4,737,253           | 18.1                | 19.7              |
| Brokered certificates of deposit <sup>(2)</sup> | 4.05%                  | 3.95%             | 447,403             | 483,777             | 1.7                 | 2.0               |
| Checking accounts                               | 1.19%                  | 1.06%             | 387,990             | 378,617             | 1.5                 | 1.6               |
| Total deposits                                  | 3.02%                  | 2.88%             | <u>\$26,256,619</u> | <u>\$24,071,012</u> | <u>100.0%</u>       | <u>100.0%</u>     |

<sup>(1)</sup> Represents retail certificates of deposit, including retail brokered certificates of deposit.

<sup>(2)</sup> Represents institutional certificates of deposit.

**NOTE 10—OTHER BORROWINGS**

ETBH raises capital through the formation of trusts, which sell trust preferred stock in the capital markets. The capital securities must be redeemed in whole at the due date, which is generally 30 years after issuance. Each trust issued Floating Rate Cumulative Preferred Securities, at par with a liquidation amount of \$1,000 per capital security. The trusts use the proceeds from the sale of issuances to purchase Floating Rate Junior Subordinated Debentures issued by ETBH, guarantees the trust obligations and contributes proceeds from the sale of its subordinated debentures to E\*TRADE Bank in the form of a capital contribution.

During January and March 2007, ETBH formed two trusts, ETBH Capital Trust XXVIII and ETBH Capital Trust XXIX, respectively. Information related to these trusts is shown below (dollars in thousands):

| Trusts                    | Face Value | Maturity Date | Annual Interest Rate      |
|---------------------------|------------|---------------|---------------------------|
| ETBH Capital Trust XXVIII | \$25,000   | 2037          | 2.00% above 3-month LIBOR |
| ETBH Capital Trust XXIX   | \$15,000   | 2037          | 1.95% above 3-month LIBOR |

**NOTE 11—ACCOUNTS PAYABLE, ACCRUED AND OTHER LIABILITIES**

Accounts payable, accrued and other liabilities consist of the following (dollars in thousands):

|   | March 31, 2007      | December 31, 2006   |
|---|---------------------|---------------------|
| Deposits received for securities loaned                       | \$ 1,155,903        | \$ 1,012,831        |
| Other payables to brokers, dealers and clearing organizations | 537,357             | 350,221             |
| Accounts payable and accrued expenses                         | 253,990             | 335,117             |
| Fails to receive  | 107,587             | 84,864              |
| Derivative liabilities  | 67,012              | 78,710              |
| Subserviced loan advances                                     | 55,220              | 44,780              |
| Senior and convertible debt accrued interest                  | 25,125              | 20,125              |
| Restructuring liabilities                                     | 23,099              | 26,892              |
| Other   | 461,093             | 377,156             |
| Total accounts payable, accrued and other liabilities         | <u>\$ 2,686,386</u> | <u>\$ 2,330,696</u> |



**NOTE 12—INCOME TAXES**

Effective January 1, 2007, the Company adopted FIN 48. As a result of the implementation the Company recognized a \$14.9 million increase to its liability for unrecognized tax benefits, which was accounted for as a reduction to the beginning balance of retained earnings. The total amount of gross unrecognized tax benefits as of January 1, 2007 was \$150.4 million. Of this total amount, \$51.6 million (net of the federal benefit on state issues) represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in any future periods. This amount did not significantly change during the period ended March 31, 2007. However, the gross unrecognized tax benefit was reduced to \$122.0 million at March 31, 2007 due to tax accounting method change requests filed with the Internal Revenue Service ("IRS").

The following table summarizes the tax years that are either currently under audit or remain open under the statute of limitations and subject to examination by the major tax jurisdictions in which the Company operates:

| <u>Jurisdiction</u>           | <u>Open Tax Year</u> |
|-------------------------------|----------------------|
| Canada                        | 2001 – 2006          |
| United Kingdom                | 2005 – 2006          |
| United States                 | 2003 – 2006          |
| Various States <sup>(1)</sup> | 1996 – 2006          |

<sup>(1)</sup> Includes California, Georgia, New York and Virginia.

It is likely that certain examinations may be settled or the statute of limitations could expire with regards to other tax filings, in the next twelve months. Additionally, the Company filed a tax accounting method change request with the IRS, which would resolve an outstanding uncertain tax position. Such events would generally reduce the Company's unrecognized tax benefits, either because the tax positions are sustained or because the Company agrees to the disallowance, by as much as \$60.0 million. Of this amount, \$51.0 million relates to positions that would not affect the Company's total tax provision or effective tax rate.

The Company's continuing practice is to recognize interest and penalties, if any, related to income tax matters in income tax expense. After the adoption of FIN 48, the Company has total gross reserves of \$15.1 million for the payment of interest as of January 1, 2007.

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**NOTE 13—EARNINGS PER SHARE**

The following table is a reconciliation of basic and diluted earnings per share (in thousands, except per share amounts):

|   | Three Months Ended<br>March 31, |                   |
|---|---------------------------------|-------------------|
|   | 2007                            | 2006              |
| <b>Basic:</b>   |                                 |                   |
| Numerator:  |                                 |                   |
| Net income from continuing operations                             | \$ 169,410                      | \$ 142,984        |
| Loss from discontinued operations, net of tax                     | —                               | (513)             |
| Net income  | <u>\$ 169,410</u>               | <u>\$ 142,471</u> |
| Denominator:  |                                 |                   |
| Basic weighted-average shares outstanding                         | <u>423,786</u>                  | <u>414,679</u>    |
| <b>Diluted:</b>   |                                 |                   |
| Numerator:  |                                 |                   |
| Net income  | <u>\$ 169,410</u>               | <u>\$ 142,471</u> |
| Denominator:  |                                 |                   |
| Basic weighted-average shares outstanding                         | 423,786                         | 414,679           |
| Effect of dilutive securities:                                    |                                 |                   |
| Weighted-average options and restricted stock issued to employees | 12,121                          | 15,546            |
| Weighted-average warrants and contingent shares outstanding       | 248                             | 248               |
| Weighted-average mandatory convertible notes                      | <u>1,380</u>                    | <u>1,829</u>      |
| Diluted weighted-average shares outstanding                       | <u>437,535</u>                  | <u>432,302</u>    |
| <b>Per share:</b>   |                                 |                   |
| Basic earnings per share:   |                                 |                   |
| Earnings per share from continuing operations                     | \$ 0.40                         | \$ 0.34           |
| Loss per share from discontinued operations, net of tax           | —                               | (0.00)            |
| Net earnings per share  | <u>\$ 0.40</u>                  | <u>\$ 0.34</u>    |
| Diluted earnings per share:                                       |                                 |                   |
| Earnings per share from continuing operations                     | \$ 0.39                         | \$ 0.33           |
| Loss per share from discontinued operations, net of tax           | —                               | (0.00)            |
| Net earnings per share  | <u>\$ 0.39</u>                  | <u>\$ 0.33</u>    |

Excluded from the calculations of diluted earnings per share are 7.8 million shares of common stock for the three months ended March 31, 2006, issuable under convertible subordinated notes as the effect of applying the treasury stock method on an if-converted basis would be anti-dilutive. There were not any shares issuable under convertible subordinated notes excluded from the calculation of diluted earnings per share for the three months ended March 31, 2007.

The following options to purchase shares of common stock have not been included in the computation of diluted earnings per share as their effect would be anti-dilutive (shares in thousands, except exercise price ranges):

|   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2007                            | 2006     |
| Options excluded from computation of diluted earnings per share | 8,138                           | 2,750    |
| Exercise price ranges:  |                                 |          |
| High  | \$ 58.19                        | \$ 58.19 |
| Low   | \$ 19.11                        | \$ 18.62 |

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[Table of Contents](#)**NOTE 14—SHARE REPURCHASES**

During 2007, the Company repurchased common stock under a \$200.0 million repurchase program approved by the Board in December 2004 (the “December 2004 Plan”). The December 2004 Plan is open-ended and provides the flexibility to buy back common stock, retire debt in the open market or a combination of both. The table below shows the timing and impact of the repurchases during the three months ended March 31, 2007 (dollars in thousands, except per share amounts):

| <u>Three Months Ended</u> | <u>Total Number of<br/>Shares Purchased</u> | <u>Aggregate<br/>Price</u> | <u>Average Price<br/>Paid per Share</u> | <u>Maximum Dollar<br/>Value of Shares That<br/>May Yet be<br/>Purchased Under<br/>the December 2004 Plan</u> |
|---------------------------|---|----------------------------|---|--|
| March 31, 2007            | 1,030,000                                   | \$23,022                   | \$ 22.35                                | \$ 34,142  |

**NOTE 15—REGULATORY REQUIREMENTS*****Registered Broker-Dealers***

The Company’s broker-dealer subsidiaries are subject to the Uniform Net Capital Rule (the “Rule”) under the Securities Exchange Act of 1934 administered by the SEC, the NYSE and NASD, which requires the maintenance of minimum net capital. The minimum net capital requirements can be met under either the Aggregate Indebtedness method or the Alternative method. Under the Aggregate Indebtedness method, a broker-dealer is required to maintain minimum net capital of the greater of 6 2/3% of its aggregate indebtedness, as defined, or a minimum dollar amount. Under the Alternative method, a broker-dealer is required to maintain net capital equal to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions.

The Company uses both the Aggregate Indebtedness and the Alternative methods to compute net capital. The method used depends on the individual broker-dealer subsidiary.

As of March 31, 2007, all of the Company’s broker-dealer subsidiaries met minimum net capital requirements. Total required net capital was \$0.2 billion at March 31, 2007. In addition, the Company’s broker-dealer subsidiaries had excess net capital of \$0.7 billion at March 31, 2007.

***Banking***

During the period ended March 31, 2007, ETC became a wholly-owned operating subsidiary of E\*TRADE Bank. ETC continues to be an SEC-registered broker-dealer and is included in the minimum net capital requirements under the Rule. E\*TRADE Bank is subject to various regulatory capital requirements administered by Federal banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on E\*TRADE Bank’s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, E\*TRADE Bank must meet specific capital guidelines that involve quantitative measures of E\*TRADE Bank’s assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. E\*TRADE Bank’s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require E\*TRADE Bank to maintain minimum amounts and ratios of Total and Tier I Capital to risk-weighted assets and Tier I Capital to adjusted total assets. As shown in the table below, at March 31, 2007, the most recent date of notification, the OTS categorized E\*TRADE Bank as “well capitalized” under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed E\*TRADE Bank’s categorization. At March 31, 2007, management believes that E\*TRADE Bank meets all capital adequacy requirements to which it is subject. However, events beyond management’s control, such as

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fluctuations in interest rates or a downturn in the economy in areas in which E\*TRADE Bank's loans or securities are concentrated, could adversely affect future earnings and E\*TRADE Bank's ability to meet its future capital requirements.

E\*TRADE Bank's required actual capital amounts and ratios are presented in the table below (dollars in thousands):

|   | Actual      |        | Minimum Required to Qualify as Adequately Capitalized |       | Minimum Required to be Well Capitalized Under Prompt Corrective Action Provisions |        |
|---|-------------|--------|---|-------|---|--------|
|   | Amount      | Ratio  | Amount  | Ratio | Amount  | Ratio  |
| <b>March 31, 2007<sup>(1)</sup>:</b>    |             |        |   |       |   |        |
| Total Capital to risk-weighted assets   | \$3,503,086 | 10.48% | >\$2,672,962  | >8.0% | >\$ 3,341,203   | >10.0% |
| Tier I Capital to risk-weighted assets  | \$3,435,097 | 10.28% | >\$1,336,481  | >4.0% | >\$ 2,004,722   | > 6.0% |
| Tier I Capital to adjusted total assets | \$3,435,097 | 6.24%  | >\$2,203,382  | >4.0% | >\$ 2,754,228   | > 5.0% |
| <b>December 31, 2006:</b>               |             |        |   |       |   |        |
| Total Capital to risk-weighted assets   | \$2,593,081 | 10.55% | >\$1,967,129  | >8.0% | >\$ 2,458,911   | >10.0% |
| Tier I Capital to risk-weighted assets  | \$2,525,453 | 10.27% | >\$ 983,565   | >4.0% | >\$ 1,475,347   | > 6.0% |
| Tier I Capital to adjusted total assets | \$2,525,453 | 6.07%  | >\$1,665,062  | >4.0% | >\$ 2,081,328   | > 5.0% |

(1) Capital amounts and ratios include ETC.

## NOTE 16—COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS

### Legal Matters

#### Litigation Matters

In June 2002, the Company acquired from MarketXT Holdings, Inc. (formerly known as "Tradescape Corporation") the following entities: Tradescape Securities, LLC; Tradescape Technologies, LLC; and Momentum Securities, LLC. Disputes subsequently arose between the parties regarding the responsibility for liabilities that first became known to the Company after the sale. On April 8, 2004, MarketXT filed a complaint in the United States District Court for the Southern District of New York against the Company, certain of its officers and directors, and other third parties, including SBI and Softbank Corporation, alleging that defendants were preventing plaintiffs from obtaining certain contingent payments allegedly due, and as a result, claiming damages of \$1.5 billion. On April 9, 2004, the Company filed a complaint in the United States District Court for the Southern District of New York against certain directors and officers of MarketXT seeking declaratory relief and unspecified monetary damages for defendants' fraud in connection with the 2002 sale, including, but not limited to, having presented the Company with fraudulent financial statements regarding the condition of Momentum Securities, LLC during the due diligence process. Subsequently, MarketXT was placed into bankruptcy, and the Company filed an adversary proceeding against MarketXT and others in January 2005, seeking declaratory relief, compensatory and punitive damages, in those Chapter 11 bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York entitled, "In re MarketXT Holdings Corp., Debtor." In that same court, the Company filed a separate adversary proceeding against Omar Amanat in those Chapter 7 bankruptcy proceedings entitled, "In re Amanat, Omar Shariff." In October 2005, MarketXT answered the Company's adversary proceeding and asserted its counterclaims, subsequently amending its claims in 2006 to add a \$326 million claim for "promissory estoppel" in which MarketXT alleged, for the first time, that the Company breached a prior promise to purchase the acquired entities in 1999-2000. In April 2006, Omar Amanat answered the Company's separate adversary proceeding against him and asserted his counterclaims. In separate motions before the Bankruptcy Court, the Company has moved to dismiss certain counterclaims brought by MarketXT including those described above, as well as certain counterclaims brought by Mr. Amanat. In a ruling dated September 29, 2006, the Bankruptcy Court in the MarketXT case granted the Company's motion to dismiss four of the six bases upon which MarketXT asserts its fraud claims against the Company; its conversion claim; and its demand for punitive damages. In the same ruling, the Bankruptcy Court denied in its entirety

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MarketXT's competing motion to dismiss the Company's claims against it. On October 26, 2006, the Bankruptcy Court subsequently dismissed MarketXT's "promissory estoppel" claim. The Company continues to believe that the respective claims brought against it by MarketXT and Omar Amanat are without merit, and the Company will continue both to vigorously defend itself against all such claims and to fully pursue its own claims and damages as described above.

An unfavorable outcome in any matter that is not covered by insurance could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in the Company's favor, the defense of such litigation could entail considerable cost or the diversion of the efforts of management, either of which could have a material adverse effect on the Company's results of operation. In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business which could have a material adverse effect on its financial position, results of operations or cash flows. The Company contests liability or the amount of claimed damages in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages, or where investigation or discovery have yet to be completed, 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 any eventual settlement, fine, penalty or other relief might be. Subject to the foregoing, the Company believes that the outcome of any such pending matter will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome could be material to the Company's or a business segment's operating results in the future, depending, among other things, upon the Company's or business segment's income for such period.

### *Regulatory Matters*

The securities and banking industries are subject to extensive regulation under Federal, state and applicable international laws. As a result, the Company is required to comply with many complex laws and rules, and its ability to comply is dependent in part on the establishment and maintenance of a qualified compliance system. From time to time, the Company has been threatened with or named as a defendant in, lawsuits, arbitrations and administrative claims involving securities, banking and other matters. The Company is also subject to periodic regulatory audits and inspections. Compliance and trading problems that are reported to regulators, such as the SEC, the NYSE, the NASD or the OTS by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal claims being filed against the Company by customers or disciplinary action being taken against the Company or its employees by regulators. Any such claims or disciplinary actions that are decided against the Company could have a material impact on the financial results of the Company or any of its subsidiaries.

The SEC, in conjunction with various regional securities exchanges, is conducting an inquiry into the trading activities of certain specialist firms, including the Company's subsidiary E\*TRADE Capital Markets, LLC ("ETCM"), on various regional exchanges in order to determine whether such firms executed proprietary orders in a given security prior to a customer order in the same security (a practice commonly known as "trading ahead") during the period 1999—2005. The SEC has indicated that it will seek disgorgement, prejudgment interest, and penalties from any firm found to have engaged in trading ahead activity to the detriment of its customers during that time period. It is possible that such sanctions, if imposed against ETCM, could have a material impact on the financial results of the Company during the period in which such sanctions are imposed. The Company and ETCM are cooperating with the investigation.

### *Insurance*

The Company maintains insurance coverage that management believes is reasonable and prudent. The principal insurance coverage it maintains covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts

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against the Company; and errors and omissions. The Company believes that such insurance coverage is adequate for the purpose of its business. The Company's ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

### *Reserves*

For all legal matters, reserves are established in accordance with SFAS No. 5. Once established, reserves are adjusted based on available information when an event occurs requiring an adjustment.

### *Commitments*

In the normal course of business, the Company makes various commitments to extend credit and incur contingent liabilities that are not reflected in the consolidated balance sheet. Significant changes in the economy or interest rates influence the impact that these commitments and contingencies have on the Company in the future.

### *Loans*

The Company had the following mortgage loan commitments (dollars in thousands):

|                 | March 31, 2007 |               |              |
|-----------------|----------------|---------------|--------------|
|                 | Fixed Rate     | Variable Rate | Total        |
| Purchase loans  | \$ —           | \$ 1,216,189  | \$ 1,216,189 |
| Originate loans | \$ 643,281     | \$ 293,236    | \$ 936,517   |
| Sell loans      | \$ 47,170      | \$ 3,310      | \$ 50,480    |

### *Securities, Unused Lines of Credit and Certificates of Deposit*

At March 31, 2007, the Company had commitments to purchase \$1.6 billion and sell \$0.9 billion in securities. In addition, the Company had approximately \$4.1 billion of certificates of deposit scheduled to mature in less than one year and \$7.9 billion of unfunded commitments to extend credit.

### *Guarantees*

The Company provides guarantees to investors purchasing mortgage loans, which are considered standard representations and warranties within the mortgage industry. The primary guarantees are as follows:

- The mortgage and the mortgage note have been duly executed and each is the legal, valid and binding obligation of the Company, enforceable in accordance with its terms. The mortgage has been duly acknowledged and recorded and is valid. The mortgage and the mortgage note are not subject to any right of rescission, set-off, counterclaim or defense, including, without limitation, the defense of usury, and no such right of rescission, set-off, counterclaim or defense has been asserted with respect thereto. If these claims prove to be untrue, the investor can require the Company to repurchase the loan and return all loan purchase and servicing release premiums.
- Should any eligible mortgage loan delivered pay off prior to the receipt of the first payment, the loan purchase and servicing release premiums shall be fully refunded.
- Should any eligible mortgage loan delivered to an investor pay off between the receipt of the first payment and a contractually designated period of time (typically 60—120 days from the date of purchase), the servicing release premiums shall be fully refunded.

Management has determined that quantifying the potential liability exposure is not meaningful due to the nature of the standard representations and warranties, which rarely result in loan repurchases. The current

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carrying amount of the liability recorded at March 31, 2007 is \$0.3 million, which the Company considers adequate based upon analysis of historical trends and current economic conditions for these guarantees.

ETBH raises capital through the formation of trusts, which sell trust preferred stock in the capital markets. The capital securities must be redeemed in whole at the due date, which is generally 30 years after issuance. Each trust issues Floating Rate Cumulative Preferred Securities at par, with a liquidation amount of \$1,000 per capital security. The proceeds from the sale of issuances are invested in ETBH's Floating Rate Junior Subordinated Debentures.

During the 30-year period prior to the redemption of the Floating Rate Cumulative Preferred Securities, ETBH guarantees the accrued and unpaid distributions on these securities, as well as the redemption price of the securities and certain costs that may be incurred in liquidating, terminating or dissolving the trusts (all of which would otherwise be payable by the trusts). At March 31, 2007, management estimated that the maximum potential liability under this arrangement is equal to approximately \$441.8 million or the total face value of these securities plus dividends, which may be unpaid at the termination of the trust arrangement.

### **NOTE 17—SEGMENT INFORMATION**

The segments presented below reflect the manner in which the Company's chief operating decision maker assesses the Company's performance. The Company has two segments: retail and institutional.

Retail includes:

- investing, trading, banking and lending products and services to individuals; and
- stock plan administration products and services.

Institutional includes:

- balance sheet management activities including generation of institutional net interest spread, gain on sales of loans and securities, net and management income;
- market-making; and
- global equity execution and settlement services.

The retail segment originates loans through lending activities. Retail segment loan originations that are not sold directly to outside parties are sold at arm's length prices to the institutional segment which manages the Company's balance sheet. The Company evaluates the performance of its segments based on segment contribution (net revenue less expense excluding operating interest). All corporate overhead, administrative and technology charges are allocated to segments either in proportion to their respective direct costs or based upon specific operating criteria.

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Financial information for the Company's reportable segments is presented in the following tables (dollars in thousands):

|   | Three Months Ended March 31, 2007 |                  |                             |                   |
|---|-----------------------------------|------------------|-----------------------------|-------------------|
|   | Retail                            | Institutional    | Eliminations <sup>(1)</sup> | Total             |
| <b>Revenue:</b>   |                                   |                  |                             |                   |
| Operating interest income                                     | \$ 457,764                        | \$ 671,243       | \$ (299,212)                | \$ 829,795        |
| Operating interest expense                                    | (230,283)                         | (508,138)        | 299,212                     | (439,209)         |
| Net operating interest income                                 | 227,481                           | 163,105          | —                           | 390,586           |
| Provision for loan losses                                     | —                                 | (21,186)         | —                           | (21,186)          |
| Net operating interest income after provision for loan losses | 227,481                           | 141,919          | —                           | 369,400           |
| Commission  | 123,305                           | 35,688           | —                           | 158,993           |
| Fees and service charges                                      | 54,203                            | 7,475            | (2,180)                     | 59,498            |
| Principal transactions  | —                                 | 30,082           | —                           | 30,082            |
| Gain on sales of loans and securities, net                    | 4,911                             | 12,464           | —                           | 17,375            |
| Other revenue   | 9,751                             | 41               | (142)                       | 9,650             |
| Total non-interest income                                     | 192,170                           | 85,750           | (2,322)                     | 275,598           |
| Total net revenue   | 419,651                           | 227,669          | (2,322)                     | 644,998           |
| <b>Expense excluding interest:</b>                            |                                   |                  |                             |                   |
| Compensation and benefits                                     | 80,296                            | 43,486           | —                           | 123,782           |
| Clearing and servicing  | 20,761                            | 48,813           | (2,322)                     | 67,252            |
| Advertising and market development                            | 43,924                            | 1,668            | —                           | 45,592            |
| Communications  | 22,795                            | 3,361            | —                           | 26,156            |
| Professional services   | 15,099                            | 9,886            | —                           | 24,985            |
| Depreciation and amortization                                 | 14,809                            | 4,574            | —                           | 19,383            |
| Occupancy and equipment                                       | 20,572                            | 3,007            | —                           | 23,579            |
| Amortization of other intangibles                             | 9,619                             | 649              | —                           | 10,268            |
| Facility restructuring and other exit activities              | 1,017                             | (284)            | —                           | 733               |
| Other   | 19,301                            | 13,374           | —                           | 32,675            |
| Total expense excluding interest                              | 248,193                           | 128,534          | (2,322)                     | 374,405           |
| Segment income  | <u>\$ 171,458</u>                 | <u>\$ 99,135</u> | <u>\$ —</u>                 | <u>\$ 270,593</u> |

<sup>(1)</sup> Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing and order flow rebates.



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|   | Three Months Ended March 31, 2006 |               |                             |            |
|---|-----------------------------------|---------------|-----------------------------|------------|
|   | Retail                            | Institutional | Eliminations <sup>(1)</sup> | Total      |
| <b>Revenue:</b>   |                                   |               |                             |            |
| Operating interest income                                     | \$ 318,202                        | \$ 453,476    | \$ (177,384)                | \$ 594,294 |
| Operating interest expense                                    | (112,282)                         | (334,607)     | 177,384                     | (269,505)  |
| Net operating interest income                                 | 205,920                           | 118,869       | —                           | 324,789    |
| Provision for loan losses                                     | —                                 | (10,197)      | —                           | (10,197)   |
| Net operating interest income after provision for loan losses | 205,920                           | 108,672       | —                           | 314,592    |
| Commission  | 135,864                           | 40,005        | —                           | 175,869    |
| Fees and service charges                                      | 53,344                            | 6,791         | (2,273)                     | 57,862     |
| Principal transactions  | —                                 | 30,692        | —                           | 30,692     |
| Gain on sales of loans and securities, net                    | 8,727                             | 2,901         | —                           | 11,628     |
| Other revenue   | 9,299                             | 111           | (1,704)                     | 7,706      |
| Total non-interest income                                     | 207,234                           | 80,500        | (3,977)                     | 283,757    |
| Total net revenue   | 413,154                           | 189,172       | (3,977)                     | 598,349    |
| <b>Expense excluding interest:</b>                            |                                   |               |                             |            |
| Compensation and benefits                                     | 71,207                            | 44,781        | —                           | 115,988    |
| Clearing and servicing  | 17,365                            | 49,900        | (3,977)                     | 63,288     |
| Advertising and market development                            | 33,055                            | 1,726         | —                           | 34,781     |
| Communications  | 28,483                            | 2,925         | —                           | 31,408     |
| Professional services   | 22,318                            | 5,437         | —                           | 27,755     |
| Depreciation and amortization                                 | 14,568                            | 4,221         | —                           | 18,789     |
| Occupancy and equipment                                       | 18,987                            | 1,517         | —                           | 20,504     |
| Amortization of other intangibles                             | 9,873                             | 1,459         | —                           | 11,332     |
| Facility restructuring and other exit activities              | 375                               | (628)         | —                           | (253)      |
| Other   | 19,589                            | 11,416        | —                           | 31,005     |
| Total expense excluding interest                              | 235,820                           | 122,754       | (3,977)                     | 354,597    |
| Segment income  | \$ 177,334                        | \$ 66,418     | \$ —                        | \$ 243,752 |

<sup>(1)</sup> Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing and order flow rebates.

*Segment Assets*

|                         | Retail       | Institutional | Eliminations | Total        |
|-------------------------|--------------|---------------|--------------|--------------|
| As of March 31, 2007    | \$14,496,703 | \$45,638,379  | \$ —         | \$60,135,082 |
| As of December 31, 2006 | \$13,864,334 | \$39,874,969  | \$ —         | \$53,739,303 |

No single customer accounted for more than 10% of total net revenue for the three months ended March 31, 2007 and 2006.

**NOTE 18—SUBSEQUENT EVENT**

On April 18, 2007, the Company announced that its Board of Directors authorized an additional \$250.0 million common stock repurchase program (the “April 2007 Plan”). The April 2007 Plan is open-ended and allows for the repurchase of common stock on the open market, in private transactions or a combination of both.

**ITEM 4. CONTROLS AND PROCEDURES**

- (a) Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of the Company's "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 ("Exchange Act") Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report, have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.
- (b) Our Chief Executive Officer and our Chief Financial Officer have evaluated the changes to the Company's internal control over financial reporting that occurred during our last fiscal quarter ended March 31, 2007, as required by paragraph (d) of Exchange Act Rules 13a-15 and 15d-15, and have concluded that there were no such changes that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II—OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

In June 2002, the Company acquired from MarketXT Holdings, Inc. (formerly known as “Tradescape Corporation”) the following entities: Tradescape Securities, LLC; Tradescape Technologies, LLC; and Momentum Securities, LLC. Disputes subsequently arose between the parties regarding the responsibility for liabilities that first became known to the Company after the sale. On April 8, 2004, MarketXT filed a complaint in the United States District Court for the Southern District of New York against the Company, certain of its officers and directors, and other third parties, including Softbank Investment Corporation (“SBI”) and Softbank Corporation, alleging that defendants were preventing plaintiffs from obtaining certain contingent payments allegedly due, and as a result, claiming damages of \$1.5 billion. On April 9, 2004, the Company filed a complaint in the United States District Court for the Southern District of New York against certain directors and officers of MarketXT seeking declaratory relief and unspecified monetary damages for defendants’ fraud in connection with the 2002 sale, including, but not limited to, having presented the Company with fraudulent financial statements regarding the condition of Momentum Securities, LLC during the due diligence process. Subsequently, MarketXT was placed into bankruptcy, and the Company filed an adversary proceeding against MarketXT and others in January 2005, seeking declaratory relief, compensatory and punitive damages, in those Chapter 11 bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York entitled, “In re MarketXT Holdings Corp., Debtor.” In that same court, the Company filed a separate adversary proceeding against Omar Amanat in those Chapter 7 bankruptcy proceedings entitled, “In re Amanat, Omar Shariff.” In October 2005, MarketXT answered the Company’s adversary proceeding and asserted its counterclaims, subsequently amending its claims in 2006 to add a \$326 million claim for “promissory estoppel” in which Market XT alleged, for the first time, that the Company breached a prior promise to purchase the acquired entities in 1999-2000. In April 2006, Omar Amanat answered the Company’s separate adversary proceeding against him and asserted his counterclaims. In separate motions before the Bankruptcy Court, the Company has moved to dismiss certain counterclaims brought by MarketXT including those described above, as well as certain counterclaims brought by Mr. Amanat. In a ruling dated September 29, 2006, the Bankruptcy Court in the MarketXT case granted the Company’s motion to dismiss four of the six bases upon which MarketXT asserts its fraud claims against the Company; its conversion claim; and its demand for punitive damages. In the same ruling, the Bankruptcy Court denied in its entirety MarketXT’s competing motion to dismiss the Company’s claims against it. On October 26, 2006, the Bankruptcy Court subsequently dismissed MarketXT’s “promissory estoppel” claim. The Company continues to believe that the respective claims brought against it by MarketXT and Omar Amanat are without merit, and the Company will continue both to vigorously defend itself against all such claims and to fully pursue its own claims and damages as described above.

The SEC, in conjunction with various regional securities exchanges, is conducting an inquiry into the trading activities of certain specialist firms, including the Company’s subsidiary E\*TRADE Capital Markets, LLC (“ETCM”), on various regional exchanges in order to determine whether such firms executed proprietary orders in a given security prior to a customer order in the same security (a practice commonly known as “trading ahead”) during the period 1999—2005. The SEC has indicated that it will seek disgorgement, prejudgment interest, and penalties from any firm found to have engaged in trading ahead activity to the detriment of its customers during that time period. It is possible that such sanctions, if imposed against ETCM, could have a material impact on the financial results of the Company during the period in which such sanctions are imposed. The Company and ETCM are cooperating with the investigation.

An unfavorable outcome in any matter that is not covered by insurance could have a material adverse effect on our business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in our favor, the defense of such litigation could entail considerable cost or the diversion of the efforts of management, either of which could have a material adverse effect on our results of operations. In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business which could have a material adverse effect on our financial position, results of operations or cash flows.

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We maintain insurance coverage that we believe is reasonable and prudent. The principal insurance coverage we maintain covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts against the Company; and errors and omissions. We believe that such insurance coverage is adequate for the purpose of our business. Our ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

**ITEM 1A. RISK FACTORS**

There have been no material changes in our risk factors from those disclosed in our 2006 Annual Report on Form10-K.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On December 15, 2004, the Company announced that its Board of Directors approved a \$200.0 million repurchase program (the “December 2004 Plan”). The December 2004 Plan is open-ended and provides the flexibility to buy back common stock, retire debt or a combination of both. The Company may conduct these repurchases on the open market, in private transactions or a combination of both. The table below shows the timing and impact of the repurchases during the three months ended March 31, 2007 (dollars in thousands, except per share amounts):

| <u>Month</u>  | <u>Total Number of<br/>Shares Purchased</u> | <u>Average Price Paid<br/>per Share</u> | <u>Total Number of<br/>Shares Purchased<br/>as<br/>Part of the<br/>December 2004 Plan</u> | <u>Maximum Dollar Value<br/>of Shares That May Yet<br/>be Purchased Under the<br/>December 2004 Plan</u> |
|---------------|---|---|---|--|
| January 2007  | —   | \$ —                                    | —   | \$ 57,164  |
| February 2007 | 352,000                                     | \$ 22.79                                | 352,000   | \$ 49,143  |
| March 2007    | 678,000                                     | \$ 22.12                                | 678,000   | \$ 34,142  |
| Total         | <u>1,030,000</u>                            | \$ 22.35                                | <u>1,030,000</u>  | \$ 34,142  |

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

- \*31.1 Certification—Section 302 of the Sarbanes-Oxley Act of 2002
- \*31.2 Certification—Section 302 of the Sarbanes-Oxley Act of 2002
- \*32.1 Certification—Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herein.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: May 10, 2007

E\*TRADE Financial Corporation  
(Registrant)

By                   /s/ MITCHELL H. CAPLAN                    
                  Mitchell H. Caplan  
                  *Chief Executive Officer*

By                   /s/ ROBERT J. SIMMONS                    
                  Robert J. Simmons  
                  *Chief Financial Officer*  
                  *(Principal Financial and Accounting Officer)*

**CERTIFICATION PURSUANT TO RULE 13a-14(a)/15d-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Mitchell H. Caplan, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of E\*TRADE Financial Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: May 10, 2007

E\*TRADE Financial Corporation  
(Registrant)

By \_\_\_\_\_ /s/ MITCHELL H. CAPLAN  
Mitchell H. Caplan  
Chief Executive Officer

**CERTIFICATION PURSUANT TO RULE 13a-14(a)/15d-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Robert J. Simmons, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of E\*TRADE Financial Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: May 10, 2007

E\*TRADE Financial Corporation  
(Registrant)

By \_\_\_\_\_ /s/ ROBERT J. SIMMONS  
Robert J. Simmons  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The certification set forth below is being submitted in connection with this Quarterly Report on Form 10-Q of E\*TRADE Financial Corporation (the "Quarterly Report") for the purpose of complying with Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 1350 of Chapter 63 of Title 18 of the United States Code.

Mitchell H. Caplan, the Chief Executive Officer and Robert J. Simmons, the Chief Financial Officer of E\*TRADE Financial Corporation, each certifies that, to the best of their knowledge:

1. the Quarterly Report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and
2. the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of E\*TRADE Financial Corporation.

Dated: May 10, 2007

/S/ MITCHELL H. CAPLAN

Mitchell H. Caplan  
*Chief Executive Officer*

/S/ ROBERT J. SIMMONS

Robert J. Simmons  
*Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*