
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2001

Commission file number 1-11921

E*TRADE Group, Inc.

(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)

4500 Bohannon Drive, Menlo Park, CA 94025
(Address of principal executive offices and zip code)

(650) 331-6000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 August 6, 2001, there were 339,117,637 shares of common stock and 2,261,624 shares exchangeable into common stock outstanding. The Exchangeable Shares, which were issued by EGI Canada Corporation in connection with the acquisition of VERSUS Technologies, Inc. (renamed E*TRADE Technologies Corporation effective January 2, 2001), are exchangeable at any time into common stock on a one-for-one basis and entitle holders to dividend, voting, and other rights equivalent to holders of the registrant's common stock.

E*TRADE GROUP, INC.

FORM 10-Q QUARTERLY REPORT For the Quarter Ended June 30, 2001

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References to E*TRADE, Company, “we”, “us” and “our” in this Form 10-Q refer to E*TRADE Group, Inc. and its subsidiaries unless the context requires otherwise.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

E*TRADE GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (in thousands, except per share amounts) (unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Revenues:				
Transaction revenues	\$ 109,264	\$ 180,194	\$ 240,626	\$ 434,790
Interest income	298,515	258,391	615,945	501,973
Global and institutional	37,047	40,577	73,888	90,253
Other	71,185	24,949	135,677	41,660
Gross revenues	516,011	504,111	1,066,136	1,068,676
Interest expense	(206,176)	(164,841)	(425,277)	(311,450)
Provision for loan losses	(1,656)	(974)	(3,099)	(2,230)
Net revenues	308,179	338,296	637,760	754,996
Cost of services	150,458	128,582	292,893	264,161
Operating expenses:				
Selling and marketing	55,399	117,324	149,097	297,929
Technology development	23,420	33,792	45,701	77,127
General and administrative	61,906	52,188	122,148	104,739
Amortization of goodwill and other intangibles	9,022	6,908	17,021	12,205
Acquisition-related expenses	517	1,133	517	25,732
Total operating expenses	150,264	211,345	334,484	517,732
Total cost of services and operating expenses	300,722	339,927	627,377	781,893
Operating income (loss)	7,457	(1,631)	10,383	(26,897)
Non-operating income (expense):				
Corporate interest income	5,220	5,609	10,998	9,229
Corporate interest expense	(12,759)	(11,020)	(23,987)	(18,148)
Gain (loss) on investments	(13,042)	24,416	(15,573)	35,331
Equity in losses of investments	(1,811)	(1,414)	(5,152)	(2,150)
Unrealized loss on venture funds	(8,958)	(3,462)	(20,569)	(18,090)
Fair value adjustments of financial derivatives	(1,710)	—	(1,376)	—
Other	292	(970)	(408)	(1,723)
Total non-operating income (expense)	(32,768)	13,159	(56,067)	4,449
Pre-tax income (loss)	(25,311)	11,528	(45,684)	(22,448)
Income tax expense (benefit)	(12,655)	7,896	(25,897)	(1,022)
Minority interest in subsidiaries	(350)	(585)	(315)	(177)
Income (loss) before extraordinary gain on early extinguishment of debt, net of tax	(12,306)	4,217	(19,472)	(21,249)
Extraordinary gain on early extinguishment of debt, net of tax (See Note 7)	2,111	—	74	—
Net income (loss)	\$ (10,195)	\$ 4,217	\$ (19,398)	\$ (21,249)
Income (loss) per share before extraordinary gain on early extinguishment of debt:				

Basic	\$ (0.04)	\$ 0.01	\$ (0.06)	\$ (0.07)
Diluted	\$ (0.04)	\$ 0.01	\$ (0.06)	\$ (0.07)
Net income (loss) per share:				
Basic	\$ (0.03)	\$ 0.01	\$ (0.06)	\$ (0.07)
Diluted	\$ (0.03)	\$ 0.01	\$ (0.06)	\$ (0.07)
Shares used in computation of per share data (See Note 11):				
Basic	321,550	302,870	319,405	298,115
Diluted	321,550	318,731	319,405	298,115

See notes to condensed consolidated financial statements.

E*TRADE GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (in thousands, except share amounts)

	June 30, 2001	September 30, 2000
	(unaudited)	
<u>ASSETS</u>		
Cash and equivalents	\$ 185,409	\$ 175,443
Cash and investments required to be segregated under Federal or other regulations	173,454	125,862
Brokerage receivables—net	4,335,405	6,542,508
Mortgage-backed securities	3,998,938	4,188,553
Loans receivable—net of allowance for loan losses of \$15,080 at June 30, 2001 and \$10,930 at September 30, 2000	6,911,940	4,172,754
Investments	2,080,166	985,218
Property and equipment—net	414,399	334,262
Goodwill and other intangibles	492,227	484,166
Other assets	708,233	308,671
Total assets	<u>\$19,300,171</u>	<u>\$17,317,437</u>
<u>LIABILITIES AND SHAREOWNERS' EQUITY</u>		
Liabilities:		
Brokerage payables	\$ 4,255,376	\$ 6,055,530
Banking deposits	7,687,006	4,721,801
Borrowings by bank subsidiary	3,832,887	3,531,000
Convertible subordinated notes	945,000	650,000
Accounts payable, accrued and other liabilities	749,119	471,626
Total liabilities	<u>17,469,388</u>	<u>15,429,957</u>
Company-obligated mandatorily redeemable preferred capital securities of subsidiary trusts holding solely junior subordinated debentures of ETFC (redemption value \$32,400)	<u>30,779</u>	<u>30,647</u>
Commitments and contingencies		
Shareowners' equity:		
Preferred stock, shares authorized: 1,000,000; issued and outstanding: none at June 30, 2001 and September 30, 2000	—	—
Shares exchangeable into common stock, \$.01 par value, shares authorized: 10,644,223; issued and outstanding: 2,823,206 at June 30, 2001 and 5,619,543 at September 30, 2000	28	56
Common stock, \$.01 par value, shares authorized: 600,000,000; issued and outstanding: 334,394,381 at June 30, 2001 and 304,504,764 at September 30, 2000	3,344	3,045
Additional paid-in capital	2,012,665	1,814,581
Unearned Employee Stock Ownership Plan shares	(1,157)	(1,560)
Shareowners' notes receivable	(31,644)	(19,103)
Deferred stock compensation	(34,521)	—
Accumulated deficit	(24,953)	(6,908)
Accumulated other comprehensive income (loss)	(123,758)	66,722
Total shareowners' equity	<u>1,800,004</u>	<u>1,856,833</u>
Total liabilities and shareowners' equity	<u>\$19,300,171</u>	<u>\$17,317,437</u>

See notes to condensed consolidated financial statements.

E*TRADE GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30,	
	2001	2000
Net cash used in operating activities	\$ (71,106)	\$ (286,464)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of mortgage-backed securities, available-for-sale securities, and other investments, net of securities received in business acquisitions	(13,436,885)	(5,595,325)
Proceeds from sales, maturities of and principal payments on mortgage-backed securities, available-for-sale securities, and other investments	13,483,144	4,072,880
Net increase in loans receivable, net of loans received in business acquisitions	(1,250,753)	(1,122,727)
(Increase) decrease in restricted deposits	165	(21,686)
Purchases of property and equipment, net of property and equipment received in business acquisitions	(96,234)	(104,030)
Other	(86,545)	(7,926)
Net cash used in investing activities	(1,387,108)	(2,778,814)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in banking deposits	1,936,797	1,273,752
Advances from the Federal Home Loan Bank of Atlanta	1,175,300	1,222,000
Payments on advances from the Federal Home Loan Bank of Atlanta	(1,925,839)	(565,000)
Net increase (decrease) in securities sold under agreements to repurchase	(45,927)	440,842
Net proceeds from convertible subordinated notes	315,250	631,312
Proceeds from payments of principal and prepayments of interest on related party loans, net of loans issued	2,465	—
Proceeds from issuance of common stock from associate stock transactions	20,497	44,508
Proceeds from bank loans and lines of credit, net of transaction costs	(538)	74,920
Payments on bank loans and lines of credit	(28,498)	(151,843)
Repayment of capital lease obligations	(6,359)	(5,538)
Issuance of shareowners' notes receivable	(12,500)	(18,607)
Other	545	177
Net cash provided by financing activities	1,431,193	2,946,523
DECREASE IN CASH AND EQUIVALENTS	(27,021)	(118,755)
CASH AND EQUIVALENTS—Beginning of period	212,430	326,227
CASH AND EQUIVALENTS—End of period	\$ 185,409	\$ 207,472
SUPPLEMENTAL DISCLOSURES:		
Non-cash investing and financing activities:		
Unrealized loss on available-for-sale securities	\$ (75,133)	\$ (317,130)
Tax benefit on exercise of stock options	\$ 8,618	\$ 17,481
Assets acquired under capital lease obligations	\$ 2,148	\$ 1,054
Change in financial derivatives recorded at fair market value	\$ (143,778)	\$ —
Deferred stock compensation	\$ 34,521	\$ —
Reclassification of loans held for investment to loans held for sale	\$ 802,865	\$ —
Purchase acquisitions, net of cash acquired:		
Common stock issued and stock options assumed	\$ 96,202	\$ 87,943
Cash paid, less acquired (including acquisition costs)	1,521	5,018
Liabilities assumed	4,763	17,793
Reduction in payable for purchase of international subsidiary	(12,341)	—
Carrying value of joint-venture investment	1,258	—
Fair value of assets acquired (including goodwill of \$35,010 and \$90,930)	\$ 91,403	\$ 110,754

See notes to condensed consolidated financial statements.

E*TRADE GROUP, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements include E*TRADE Group, Inc., referred to in this Form 10-Q as the Parent, a financial services holding company, and its subsidiaries, collectively referred to in this Form 10-Q as the Company or E*TRADE, including but not limited to E*TRADE Securities, Incorporated, referred to in this Form 10-Q as E*TRADE Securities, a securities broker-dealer, TIR (Holdings) Limited, referred to in

this Form 10-Q as TIR, a provider of global securities brokerage and other related services to institutional clients, and E*TRADE Financial Corporation, referred to in this Form 10-Q as ETFC, a provider of financial services whose primary business is conducted by E*TRADE Bank, referred to in this Form 10-Q as the Bank, a federally chartered savings bank that provides deposit accounts insured by the Federal Deposit Insurance Corporation, commonly referred to as the FDIC, to customers nationwide.

On January 22, 2001, the Company changed its fiscal year end from September 30 to December 31.

The unaudited condensed consolidated financial statements of the Company include the accounts of the Parent and its majority owned subsidiaries. Intercompany accounts and transactions are eliminated in consolidation. Entities in which there is at least a 20% ownership or in which there are other indicators of significant influence are generally accounted for by the equity method; those in which there is a less than 20% ownership are generally carried at cost.

These unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission, commonly referred to as the SEC, and, in the opinion of management, reflect adjustments consisting only of normal recurring adjustments necessary to present fairly the financial position, results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the United States of America. These unaudited condensed consolidated financial statements should be read in conjunction with the audited annual consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2000.

Certain prior period items in these unaudited condensed consolidated financial statements have been reclassified to conform to the current period presentation.

NOTE 2. BUSINESS COMBINATIONS

In May 2001, the Company entered into an agreement to acquire WebStreet, Inc., referred to in this Form 10-Q as WebStreet, parent company of WebStreet Securities, Inc., referred to in this Form 10-Q as WebStreet Securities, an online brokerage firm, for an aggregate purchase price of approximately \$46.3 million, comprised of approximately 4.9 million shares of the Company's common stock valued at \$43.5 million, the assumption of approximately 418,000 warrants valued at approximately \$700,000, and acquisition costs of approximately \$2.1 million. Through the acquisition of WebStreet, the Company expects to increase its customer base, advancing its diversified online financial services model. As of June 30, 2001, the Company had obtained a controlling interest in WebStreet and completed the acquisition of all its outstanding shares by August 6, 2001. The acquisition was accounted for using the purchase method of accounting and the results of WebStreet's operations will be combined with those of the Company from the date of acquisition. The purchase price exceeded the fair value of the tangible assets acquired by approximately \$35.0 million, which has been preliminarily allocated to the active brokerage accounts acquired in the June 30, 2001 balance sheet. The value allocated to active accounts acquired will be amortized over seven years using an accelerated method. The purchase price allocation at June 30, 2001 is preliminary and has been allocated based on the estimated fair value of net tangible and intangible assets acquired.

On February 1, 2001, the Company acquired LoansDirect, Inc., which merged into and was renamed E*TRADE Mortgage Corporation, referred to in this Form 10-Q as E*TRADE Mortgage, on June 15, 2001, an alternative distribution mortgage originator, for an aggregate purchase price of approximately \$36.0 million, comprised of approximately 3.0 million shares of the Company's common stock valued at \$33.0 million, the assumption of vested employee stock options of approximately \$1.5 million, and acquisition costs of approximately \$1.5 million. Through the acquisition of E*TRADE Mortgage, the Company expects to make strategic inroads into the consumer lending market, advancing its diversified online financial services model. The acquisition was accounted for using the purchase method of accounting and the results of E*TRADE Mortgage's operations have been combined with those of the Company since the date of acquisition. The purchase price exceeded the fair value of the assets acquired by approximately \$32.0 million, which was recorded as goodwill to be amortized over 15 years. The purchase price allocation at June 30, 2001 is preliminary and has been allocated based on the estimated fair value of net tangible and intangible assets acquired. Prior period results for E*TRADE Mortgage were not material. Included in other revenue, the Company recorded \$24.9 million and \$34.1 million in the three and six months ended June 30, 2001, respectively, from the gain on the sale of loans originated by E*TRADE Mortgage. Gains or losses resulting from sales of mortgage loans are recognized at the date of settlement and are based on the difference between the cash received and the asset retained by the Company, if any, and the carrying value of the related loans sold less related transaction costs. Since the Company sells its loans on a servicing released basis, gains are increased by the amount of any servicing released premiums received. Nonrefundable fees and direct costs associated with the origination of mortgage loans are deferred and recognized when the related loans are sold.

The proforma information below assumes that the acquisitions of WebStreet and E*TRADE Mortgage occurred at the beginning of calendar year 2000 and includes the effect of amortization of goodwill and the amount allocated to active brokerage accounts acquired from that date (in thousands, except per share amounts):

	Six Months Ended June 30,	
	2001	2000
Net revenues	\$649,811	\$786,417
Loss before extraordinary gain on early extinguishment of debt, net of tax	(32,987)	(38,553)
Net loss	(32,913)	(38,553)
Basic and diluted loss per share before extraordinary gain on early extinguishment of debt	\$ (0.10)	\$ (0.13)
Basic and diluted loss per share	\$ (0.10)	\$ (0.13)

The proforma information is for information purposes only and is not necessarily indicative of the results of future operations nor results that would have been achieved had the acquisition taken place at the beginning of calendar year 2000.

In October 2000, the Company completed the acquisition of PrivateAccounts, Inc., renamed E*TRADE Advisory Services, Inc. on March 26, 2001, and referred to in this Form 10-Q as E*TRADE Advisory Services, a Minneapolis-based developer of online separately managed accounts. The Company issued 618,057 shares of common stock valued at approximately \$8.7 million in exchange for 100% of the outstanding shares of E*TRADE Advisory Services. The Company also issued an equal number of shares to be held in escrow until the completion of product and asset target milestones, whereby the Company would be required to issue up to an additional \$31.0 million of the Company's common stock and, if necessary, cash consideration as incentive consideration. In March 2001, E*TRADE Advisory Services achieved a product development milestone, resulting in the release of approximately 479,000

shares valued at approximately \$4.3 million from escrow. Subsequent to the three months ended June 30, 2001, E*TRADE Advisory services achieved a second product development milestone, resulting in the release from escrow of approximately 140,000 shares and the issuance of approximately 557,000 shares valued in total at \$4.3 million. The acquisition was accounted for using the purchase method of accounting, and the results of E*TRADE Advisory Services' operations have been combined with those of the Company since the date of acquisition. The purchase price allocation at June 30, 2001 is preliminary and has been allocated based on the estimated fair value of net tangible and intangible assets acquired. Prior period results for E*TRADE Advisory Services were not material.

In October 1999, the Company entered into a joint venture agreement with Berliner Effektenbank AG and New York Broker Deutschland AG to form E*TRADE Germany AG, referred to in this Form 10-Q as E*TRADE Germany. The Company had a 60% ownership interest in this joint venture at September 30, 2000. The Company entered into an agreement to acquire the remaining 40% ownership interest in E*TRADE Germany for approximately 24.0 million Euros (approximately \$20.2 million as of October 16, 2000, the closing date of the transaction). The additional investment was comprised of approximately \$1.4 million in cash (paid in October 2000), 1.4 million shares of the Company's common stock valued at approximately \$12.3 million (paid in January 2001), and 1.4 million shares of the Company's common stock valued at approximately \$8.7 million (paid subsequent to the three months ended June 30, 2001 in July 2001). The purchase price exceeded the fair value of the assets acquired by \$19.4 million, which was recorded as goodwill to be amortized over 20 years. The acquisition was accounted for using the purchase method of accounting, and the results of E*TRADE Germany's operations have been combined with those of the Company since the date of the acquisition. The purchase price allocation at June 30, 2001 is preliminary and has been allocated based on the estimated fair value of net tangible assets acquired. Prior period results for E*TRADE Germany were not material.

NOTE 3. SALE OF INTERNATIONAL SUBSIDIARY

In November 2000, the Company sold its ownership interest in E*TRADE @ Net Bourse S.A. for approximately 80.5 million Euros (approximately \$68.0 million as of November 2000, the date of the transaction). Of this amount, approximately 8.2 million Euros (approximately \$7.0 million as of November 2000, the date of the transaction) will be held in escrow for two years, of which 50% may be released after one year. In conjunction with this transaction, the Company reacquired its licensing rights to France, as well as the ownership interests in E*TRADE SARL, E*TRADE Italy and E*TRADE Benelux, previously held by E*TRADE @ Net Bourse S.A. No gain or loss resulted from this transaction.

NOTE 4. BROKERAGE RECEIVABLES—NET AND PAYABLES

Brokerage receivables—net and payables consist of the following (in thousands):

	June 30, 2001	September 30, 2000
Receivable from customers and non-customers (less allowance for doubtful accounts of \$5,630 at June 30, 2001 and \$3,887 at September 30, 2000)	\$2,374,226	\$5,173,220
Receivable from brokers, dealers and clearing organizations:		
Net settlement and deposits with clearing organizations	63,894	89,031
Deposits paid for securities borrowed	1,873,125	1,267,109
Securities failed to deliver	808	1,970
Other	23,352	11,178
Total brokerage receivables—net	\$4,335,405	\$6,542,508
Payable to customers and non-customers	\$1,791,103	\$1,735,228
Payable to brokers, dealers and clearing organizations:		
Deposits received for securities loaned	2,456,279	4,296,399
Securities failed to receive	2,093	6,266
Other	5,901	17,637
Total brokerage payables	\$4,255,376	\$6,055,530

Receivable from and payable to brokers, dealers and clearing organizations result from the Company's brokerage activities. Receivable from customers and non-customers represents credit extended to customers and non-customers to finance their purchases of securities on margin. At June 30, 2001 and September 30, 2000, credit extended to customers and non-customers with respect to margin accounts was \$2,020 million and \$5,040 million, respectively. Securities owned by customers and non-customers are held as collateral for amounts due on margin balances, the value of which is not reflected in the accompanying consolidated balance sheets. As of June 30, 2001, the Company has received collateral primarily in connection with securities borrowed and customer margin loans with a market value of \$6,225 million, which it can sell or repledge. Of this amount, \$2,673 million has been pledged or sold as of June 30, 2001 in connection with securities loans, bank borrowings and deposits with clearing organizations. Payable to customers and non-customers represents free credit balances and other customer and non-customer funds pending completion of securities transactions. The Company pays interest on certain customer and non-customer credit balances.

NOTE 5. INVESTMENTS

Investments are comprised of trading and available-for-sale debt and equity securities, as defined under the provisions of Statement of Financial Accounting Standard No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Also included in investments are investments in entities in which the Company owns between 20% and 50%, or in which there are other indicators of significant influence. These investments are generally accounted for using the equity method; those investments in which there is a less than 20% ownership are generally carried at cost.

The carrying amounts of investments are shown below (in thousands):

June 30, 2001	September 30, 2000
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Trading securities	\$ 1,993	\$ 3,867
Available-for-sale investment securities(1)	1,911,637	861,334
Equity method and other investments:		
Joint ventures	37,055	30,492
Venture capital funds	29,948	50,974
Wit Soundview Group, Inc.	39,430	—
Archipelago	25,274	25,658
Other investments	34,829	12,893
	\$2,080,166	\$985,218
Total investments		

- (1) Includes investments in the E*TRADE Financial Sector Index Fund, E*TRADE Russell 2000 Index Fund, E*TRADE Global Titan Fund and the E*TRADE S&P 500 Fund.

Wit Soundview Group, Inc.

At September 30, 2000 E*TRADE owned a 23.6% investment in E*OFFERING Corp., referred to in this Form 10-Q as E*OFFERING, a full service, Internet-based investment bank. On October 16, 2000, Wit Soundview Group, Inc., referred to in this Form 10-Q as Wit, completed the acquisition of E*OFFERING. Under the terms of the agreement, the Company received approximately 5,324,000 shares of Wit common stock and warrants to purchase 534,705 and 1,821,936 shares of Wit common stock exercisable for \$5.99 and \$0.60 per share, respectively, exercisable immediately and expiring in February 2001 and January 2005, respectively, as well as the right to name one representative to Wit's Board of Directors. The warrants to purchase 534,705 shares of Wit common stock expired unexercised in February 2001. Concurrently with this agreement, the Company and Wit entered into certain other collateral arrangements whereby the Company acquired Wit's retail brokerage business and received 4,025,948 shares of Wit common stock and a warrant to purchase up to 2,000,000 shares of Wit common stock for \$10.25 per share, as consideration for the Company entering into a strategic alliance agreement pursuant to which Wit is the exclusive source of initial public offerings, follow-on offerings, and other investment banking products to the Company for a five year term. The warrants are exercisable if the exclusivity provisions of the strategic alliance agreement have remained in effect during the fourth and fifth years of the agreement. If, following a change of control of the Company while the exclusivity provisions are still in effect, the Company or its successor breaches the strategic alliance agreement or the acquirer fails to acknowledge that it will cause the Company to honor the exclusivity provisions thereunder, the Company will be obligated to pay Wit \$120 million less \$3.33 million for each calendar month since October 2000 (\$90.0 million as of June 30, 2001), but in no event less than \$80 million. If the Company receives fully registered and freely marketable common or preferred stock, the Company may at its option make the payment in such securities instead of cash, applying the same valuation principles as in the change of control transaction. If the Company makes such election, Wit may then elect to receive a number of shares of Wit common stock held by the Company equal in value to the payment due provided that each share of Wit common stock be valued at not less than \$10.25. In addition, any shares of Wit common stock still in escrow under the terms of the merger would be transferred to Wit. Wit would also continue, for two years after the change of control, to have the right to provide securities to the Company's retail customers on a non-exclusive basis but the exclusivity provisions would no longer be effective. In a related transaction, the Company also purchased 2,000,000 shares of Wit common stock for \$20.5 million in cash. The Company subsequently purchased 300,000 shares of Wit common stock for approximately \$1.9 million on the open market. As a result of these transactions, the Company holds an approximate 10% ownership interest in Wit, excluding the warrants held, and accounts for its investment under the equity method.

For the quarter ended June 30, 2001, Wit reported a net loss of \$267.8 million, including a goodwill impairment charge of \$249.7 million related to its acquisition of E*Offering. The Company's original carrying value for its investment in Wit common stock did not include any amount for the goodwill originally recorded by Wit in its acquisition of E*Offering because the carrying value was based on the book value of E*Offering. Accordingly, the Company would not recognize any portion of Wit's impairment charge in connection with recording its proportionate share of Wit's losses under the equity method of accounting.

Due to certain events in July 2001, the Company believes that it no longer has significant influence over Wit. Accordingly, the Company will discontinue the use of the equity method of accounting for the Company's holdings in Wit effective for the quarter ended September 30, 2001 and the Company will account for its investment in Wit under the cost method. At June 30, 2001, the market value of the Wit securities held by the Company was approximately \$22.1 million compared with the Company's carrying value of \$39.4 million. The market price of Wit declined below the Company's carrying value during February 2001; should the market price of Wit remain below its carrying value through September 30, 2001, the Company believes that this will indicate that the decline in value is other than temporary, requiring a write down of this investment to its then fair market value.

Publicly-Traded Equity Securities

Included in available-for-sale securities are investments in several companies that are publicly-traded and carried at fair value. In June 2001, the Company determined there had been an other than temporary decline in the value of its technology stocks, given market conditions combined with a sustained decline in the value of some of its publicly traded equities in technology companies over the past six months. As a result, the Company wrote down the related investments to their fair market value at June 30, 2001, recognizing pre-tax losses of approximately \$9.3 million in the three months ended June 30, 2001. Unrealized gains related to available-for-sale securities were \$920,000 and \$186.3 million at June 30, 2001 and September 30, 2000, respectively. Unrealized losses related to these investments were none and \$2.8 million at June 30, 2001 and September 30, 2000, respectively.

Other Investments

The Company has also made investments in non-public, venture capital-backed high technology companies with which it does business and which provide Internet-based services. These investments represent less than 20% of the outstanding shares of these companies and are accounted for under the cost method. The Company also has investments in venture funds which are accounted for under the equity method.

NOTE 6. RELATED PARTY TRANSACTIONS

Related Party Loans

In May 2001, the Company made a loan to an executive officer of the Company in the aggregate principal amount of \$2.0 million. The loan accrues

interest at a rate of 4.25% annually. The principal amount and accrued interest on the loan are due in May 2002. The loan is collateralized by real property owned by the officer.

In March 2001, the Company made a loan to an executive officer of the Company in the aggregate principal amount of \$0.1 million. The loan accrues interest at a rate of 4.68% annually. Accrued interest on the loan is due to be paid in March 2002, and the remaining interest and principal is due in March 2003. The loan is collateralized by shares of the Company's common stock currently held in the name of the officer.

In February 2001, an executive officer of the Company repaid \$2.9 million of his relocation loan. The remainder of the loan of \$1.3 million, due in May 2005, is collateralized by shares of the Company's common stock currently held in the name of the officer.

In November and December 2000, the Company made loans to two executive officers and a director of the Company in the aggregate principal amount of \$30.5 million. The loans accrue interest at rates of between 6.09% and 6.10% annually. The principal amounts of \$0.5 million, \$15.0 million, and \$15.0 million are due in December 2002, November 2005, and November 2010, respectively. One of the \$15.0 million loans is collateralized by real property owned by an executive officer. The other \$15.0 million loan is collateralized by equity interests in various limited liability companies and real property owned by a director.

Related party loans receivable are recorded in other assets (\$39.5 million at June 30, 2001 and \$9.9 million at September 30, 2000).

Other

In January 2001, a wholly owned subsidiary of the Company purchased residential property from an executive officer for a total purchase price of approximately \$1.7 million paid in cash.

See Note 8 for additional related party transactions.

NOTE 7. SUBORDINATED NOTES AND OTHER BORROWINGS

The Company recorded an extraordinary gain on early extinguishment of debt of \$2.1 million (net of tax expense of \$1.8 million) and \$0.1 million (net of tax expense of \$600,000) in the three and six months ended June 30, 2001, respectively. In the three and six months ended June 30, 2001, amounts recorded included a \$5.0 million gain (net of tax expense of \$3.4 million), on exchanges in the aggregate of \$30.0 million of the Company's 6% convertible subordinated notes for 2.7 million shares of common stock, offset by a \$2.9 million loss (net of tax benefit of \$1.6 million) and a \$4.9 million loss (net of tax benefit of \$2.8 million) in the three and six months ended June 30, 2001, respectively, recorded as a result of the early redemptions of \$100 million and \$600 million, respectively, of adjustable and fixed rate advances from the Federal Home Loan Bank of Atlanta, referred to in this Form 10-Q as the FHLB. The FHLB advances were entered into as a result of normal funding requirements of the Company's banking operations. The losses consisted primarily of prepayment penalties and costs associated with these early redemptions.

On May 29, 2001, the Company completed a Rule 144A offering of \$325 million convertible subordinated notes due May 2008. The notes are convertible, at the option of the holder, into a total of approximately 29.7 million shares of the Company's common stock at a conversion price of \$10.925 per share. The notes bear interest at 6.75%, payable semiannually, are non-callable for three years and may then be called by the Company at a premium, which declines over time. The holders have the right to require redemption at a premium in the event of a change in control or other defined redemption event. The Company expects to use the net proceeds for general corporate purposes, including capital expenditures and to meet working capital needs. The Company has not identified the amounts planned to be spent on each of these areas or the timing of such expenditures. Accordingly, the Company's management will have broad discretion in the application of the net proceeds. Debt issuance costs of \$10.5 million are included in other assets and are being amortized to interest expense over the term of the notes. Had these securities been issued at the beginning of the calendar year, net loss per share would have increased to \$0.04 and \$0.08 for the three and six months ended June 30, 2001, respectively, as compared to a reported net loss per share of \$0.03 and \$0.06 for the three and six months ended June 30, 2001, due to the additional interest expense and issuance costs associated with the securities.

During the six months ended June 30, 2001, the Company has obtained term loans from financial institutions which are collateralized by equipment owned by the Company. Borrowings under these term loans bear interest at 3.0% to 3.25% above LIBOR (6.835% to 7.085% at June 30, 2001). The Company had \$17.2 million outstanding under these term loans at June 30, 2001, which is included in accounts payable, accrued and other liabilities.

In November 2000, the Company renewed a \$50 million line of credit under an agreement with a bank that expires in November 2001. The line of credit is collateralized by investment securities that are owned by the Company. Borrowings under the line of credit bear interest at 0.35% above LIBOR (total of 3.885% at June 30, 2001). The Company had no borrowings outstanding under this line of credit at June 30, 2001.

NOTE 8. SHAREOWNERS' EQUITY

Shareowners' Notes Receivable

In June 2001, the Company made a full recourse loan to one of its executive officers for approximately \$12.5 million. The proceeds from this loan were partially used to fund the purchase of shares of the Company's common stock and the associated tax liability for the exercise and hold of stock options. The loan accrues interest at the rate of 7.5% per annum. The interest on the loan is due in June 2002 with all remaining unpaid interest due upon the payment of principal in July 2002.

In December 2000, the Company made a full recourse loan to one of its executive officers for approximately \$0.5 million. The proceeds from this loan were used to fund the purchase of shares of the Company's common stock for the exercise and hold of stock options. The loan accrues interest at the rate of 6.15% per annum. The interest on the loan is due in December 2001 with all remaining unpaid interest due upon the payment of the principal in January 2002.

Deferred Stock Compensation

In April 2001, in connection with the issuance of restricted common stock to an executive officer of the Company, the Company recorded deferred stock

compensation of \$24.4 million, the fair market value of the shares on the date of grant. This amount is being amortized to expense ratably over five years, the period in which restrictions are removed on the related shares of restricted common stock.

In January 2001, in connection with the issuance of restricted common stock to certain executive officers, the Company recorded deferred stock compensation of \$14.5 million, the fair market value of the shares on the date of grant. This amount is being amortized to expense ratably over the period in which restrictions are removed on the related shares of restricted common stock, generally four years.

Amortization of deferred stock compensation for the three and six months ended June 30, 2001 was \$2.6 million and \$4.1 million, respectively.

NOTE 9. ASSOCIATE BENEFIT PLAN

Effective January 1, 2001, the Company's Board of Directors adopted a Supplemental Executive Retirement Plan, referred to in this Form 10-Q as the SERP, for certain executive officers. The purpose of the SERP is to attract, retain and motivate certain executive officers of the Company who provide valuable services to the Company and to provide those officers with flexibility to meet their retirement and estate planning needs. Funding of the SERP by the Company is discretionary. Contributions to the SERP, if any, are due at the beginning of each calendar year and are deposited into a Rabbi Trust, to which the Company retains ownership until participant benefits vest and are distributed. To receive full benefits accrued under the SERP, at the time of retirement a participating individual must have fifteen years of participation in the plan. With the exception of the Company's Chief Executive Officer, whose benefits vest immediately, no portion of a participant's benefits will become vested unless the individual has participated in the plan for at least five years. Fifty percent of participation benefits vest after five years of participation in the SERP with the remaining benefits vesting over the next five years of participation. In January 2001, the Company contributed \$12.1 million to fund its SERP obligations and will recognize related compensation expense over the vesting period for participating individuals. The Company recognized \$375,000 and \$10.1 million in compensation expense related to the SERP during the three and six months ended June 30, 2001, respectively.

NOTE 10. COMPREHENSIVE INCOME (LOSS)

The reconciliation of net income (loss) to comprehensive income (loss) is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Net income (loss)	\$ (10,195)	\$ 4,217	\$ (19,398)	\$ (21,249)
Changes in other comprehensive income (loss):				
Unrealized loss on available-for-sale securities, net of tax	(19,322)	(87,286)	(26,673)	(156,852)
Reclassification of realized losses on available-for-sale securities	(1,166)	(24,405)	(21,263)	(35,874)
Unrealized gain (loss) on derivative instruments, net of tax (see Note 15)	26,158	—	(24,810)	—
Reclassification of SFAS 133 adjustments	9,490	—	10,910	—
Cumulative translation adjustments	277	3,046	(4,020)	1,596
Total comprehensive income (loss)	\$ 5,242	\$ (104,428)	\$ (85,254)	\$ (212,379)

NOTE 11. NET INCOME (LOSS) PER SHARE

The following table sets forth the computation of the numerator and denominator used in the computation of basic and diluted net income (loss) per share (in thousands):

	Three Months Ended June 30,			Six Months Ended June 30,	
	2001	2000	2000	2001	2000
	Basic and diluted loss per share	Basic income per share	Diluted income per share	Basic and diluted loss per share	Basic and diluted loss per share
Numerator:					
Income (loss) before extraordinary gain on early extinguishment of debt	\$ (12,306)	\$ 4,217	\$ 4,217	\$ (19,472)	\$ (21,249)
Extraordinary gain on early extinguishment of debt, net of tax	2,111	—	—	74	—
Net income (loss)	\$ (10,195)	\$ 4,217	\$ 4,217	\$ (19,398)	\$ (21,249)
Denominator:					
Weighted average shares outstanding	321,550	302,870	302,870	319,405	298,115
Dilutive effect of options issued to associates	—	—	14,792	—	—
Dilutive effect of warrants outstanding	—	—	1,069	—	—
	321,550	302,870	318,731	319,405	298,115

Because the Company reported a net loss for the three months ended June 30, 2001 and for the six months ended June 30, 2001 and 2000, the

calculation of diluted net loss per share does not include common stock equivalents as they are anti-dilutive and would result in a reduction of net loss per share. If the Company had reported net income for the three months ended June 30, 2001 and for the six months ended June 30, 2001 and 2000, there would have been 6,535,000, 8,412,000 and 18,119,000 additional shares for options outstanding, respectively, and 198,000, 198,000 and 1,156,000 additional shares for warrants outstanding, respectively. Excluded from the calculation of diluted net income (loss) per share for the three and six months ended June 30, 2001 and 2000 are approximately 37,724,000, 32,661,000, 27,542,000 and 20,430,000, respectively, of shares of common stock issuable under convertible subordinated notes as the effect of applying the treasury stock method on an as-if-converted basis would be anti-dilutive in the calculation of diluted net loss per share.

The following options to purchase shares of common stock have not been included in the computation of diluted net income (loss) per share because the options' exercise price was greater than the average market price of the Company's common stock for the periods presented, and therefore, the effect would be anti-dilutive (in thousands, except exercise price data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Options excluded from computation of diluted net loss per share	18,964	13,345	18,816	11,485
Exercise price ranges:				
High	\$58.19	\$58.75	\$58.19	\$58.75
Low	\$ 7.97	\$19.72	\$ 9.18	\$22.48

NOTE 12. REGULATORY REQUIREMENTS

E*TRADE Securities is subject to the Uniform Net Capital Rule, referred to in this Form 10-Q as the Rule, under the Securities Exchange Act of 1934 administered by the SEC and the National Association of Securities Dealers Regulation, Inc., commonly referred to as the NASDR, which requires the maintenance of minimum net capital. E*TRADE Securities has elected to use the alternative method permitted by the Rule, which requires that E*TRADE Securities maintain minimum net capital equal to the greater of \$250,000 or two percent of aggregate debit balances arising from customer transactions, as defined. E*TRADE Securities had amounts in relation to the Rule as follows (in thousands, except percentage data):

	June 30, 2001	September 30, 2000
Net capital	\$347,662	\$479,036
Percentage of aggregate debit balances	15.9%	9.2%
Required net capital	\$ 43,691	\$103,747
Excess net capital	\$303,971	\$375,289

Under the alternative method, a broker-dealer may not repay subordinated borrowings, pay cash dividends or make any unsecured advances or loans to its parent or employees if such payment would result in net capital of less than 5% of aggregate debit balances or less than 120% of its minimum dollar amount requirement.

The table below summarizes the required minimum and excess capital amounts for the Company's other U.S. broker-dealer subsidiaries (in thousands):

	June 30, 2001			September 30, 2000		
	Required Net Capital	Net Capital	Excess Net Capital	Required Net Capital	Net Capital	Excess Net Capital
E*TRADE Institutional Securities, Inc.	\$250	\$ 1,424	\$ 1,174	\$ 250	\$ 1,161	\$ 911
E*TRADE Investor Select, Inc.	\$ 5	\$ 232	\$ 227	\$ 5	\$ 351	\$ 346
Marquette Securities, Inc.	\$250	\$ 515	\$ 265	\$ 250	\$ 536	\$ 286
E*TRADE Global Asset Management, Inc.	\$228	\$13,152	\$12,924	\$ 113	\$21,774	\$21,661
E*TRADE Canada Securities Corporation	\$100	\$ 286	\$ 186	\$ 100	\$ 233	\$ 133
WebStreet Securities Inc	\$925	\$ 2,339	\$ 1,414	\$2,003	\$ 7,164	\$ 5,161

The Company's broker-dealer subsidiaries located in Canada, South Africa, Australia, Europe, and South East Asia, have various and differing capital requirements, all of which were met at June 30, 2001 and September 30, 2000. The aggregate net capital, required net capital, and excess net capital of these companies at June 30, 2001, was \$70.1 million, \$29.1 million, and \$41.0 million, respectively. The aggregate net capital, required net capital, and excess net capital of these companies at September 30, 2000 was \$48.4 million, \$18.5 million, and \$29.9 million, respectively.

The Bank is also subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The 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 the Bank to maintain minimum amounts and ratios of total and Tier I capital to risk-weighted assets and of Tier I capital to average assets. Management believes that, as of June 30, 2001 the Bank has met all capital adequacy requirements to which it was subject. As of June 30, 2001 and September 30, 2000, the Office of Thrift Supervision, commonly referred to as the OTS, categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. There are no conditions or events since that

notification that management believes have changed the institution's category.

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

	Actual		Required for Capital Adequacy Purposes		Required to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of June 30, 2001:						
Core Capital (to adjusted tangible assets)	\$742,452	5.8%	>\$510,262	>4.0%	>\$637,827	> 5.0%
Tangible Capital (to tangible assets)	\$742,452	5.8%	>\$191,348	> 1.5%	N/A	N/A
Tier I Capital (to risk weighted assets)	\$742,452	11.4%	N/A	N/A	>\$390,402	> 6.0%
Total Capital (to risk weighted assets)	\$757,426	11.6%	>\$520,536	> 8.0%	>\$650,670	> 10.0%
As of September 30, 2000:						
Core Capital (to adjusted tangible assets)	\$582,058	6.5%	>\$359,874	> 4.0%	>\$449,843	> 5.0%
Tangible Capital (to tangible assets)	\$582,058	6.5%	>\$134,953	> 1.5%	N/A	N/A
Tier I Capital (to risk weighted assets)	\$582,058	16.8%	N/A	N/A	>\$207,890	> 6.0%
Total Capital (to risk weighted assets)	\$592,597	17.1%	>\$277,186	> 8.0%	>\$346,483	> 10.0%

NOTE 13. COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS

As of June 30, 2001, the Bank had commitments to purchase or originate \$334.0 million in fixed rate and \$289.5 million in variable rate loans and certificates of deposit scheduled to mature in less than one year approximating \$2.0 billion. In the normal course of business, the Bank makes various commitments to extend credit and incur contingent liabilities that are not reflected in the accompanying consolidated balance sheets.

The Company is a defendant in civil actions arising in the normal course of business. These currently include, among other actions, putative class actions alleging various causes of action for "unfair or deceptive business practices" that were filed against the Company between November 21, 1997 and March 11, 1999, as a result of various systems interruptions that the Company previously experienced.

To date, none of these putative class actions has been certified, and the Company believes that these claims are without merit and intends to defend against them vigorously. An unfavorable outcome in any of these matters for which the Company's pending insurance claims are rejected could harm the Company's business. From time to time, the Company has been threatened with, or named as a defendant in, lawsuits, arbitrations and administrative claims. Compliance and trading problems that are reported to regulators such as the SEC or the NASDR by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal arbitration claims being filed against the Company by customers and/or disciplinary action being taken against the Company by regulators. Any such claims or disciplinary actions that are decided against the Company could harm the Company's business. The Company is also subject to periodic regulatory audits and inspections.

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 so comply is dependent in large part upon the establishment and maintenance of a qualified compliance system.

The Company maintains insurance in such amounts and with such coverage, deductibles and policy limits as management believes are reasonable and prudent. The principal risks that the Company insures against are comprehensive general liability, commercial property damage, hardware/software damage, directors and officers, Fidelity (crime) Bond, and errors and omissions and employment practices liability. The Company believes that such insurance coverage is adequate for the purpose of its business.

The Company has entered into management continuity agreements with its key executive officers. These management continuity agreements provide for annual base salary compensation, stock option acceleration and severance payments in the event of termination of employment under defined circumstances within 18 months following a change in the Company's control. Base salaries are subject to adjustments according to the Company's financial performance.

NOTE 14. SEGMENT INFORMATION

Segment Information

The Company has separated its financial services into four categories: domestic retail brokerage, banking, global and institutional, and asset gathering and other. As a result of acquisitions, for the three months ended March 31, 2001, the banking segment includes the operations of E*TRADE Mortgage and for the three months ended June 30, 2001, the domestic retail brokerage and other segment includes WebStreet (see Note 2). There have been no other changes to these categories from fiscal 2000. As the asset gathering and other operations business represents emerging activities which are not material to the consolidated results for segment reporting purposes, management has aggregated asset gathering and other with domestic retail brokerage to form one of three reportable segments, with banking and global and institutional comprising the other two segments currently considered by management when it evaluates Company performance.

Financial information for the Company's reportable segments is presented in the table below, and the totals are equal to the Company's consolidated amounts as reported in the unaudited condensed consolidated financial statements (in thousands):

	Domestic Retail Brokerage & Other	Banking	Global and Institutional	Total
Three Months Ended June 30, 2001:				
Interest income-net of interest expense	\$ 51,920	\$ 38,286	\$ 2,133	\$ 92,339

Non-interest revenue-net of provision for loan losses	138,185	40,576	37,079	215,840
Net revenues	\$ 190,105	\$ 78,862	\$ 39,212	\$ 308,179
Operating income (loss)	\$ (4,369)	\$ 22,373	\$ (10,547)	\$ 7,457
Three Months Ended June 30, 2000:				
Interest income-net of interest expense	\$ 59,192	\$ 32,395	\$ 1,963	\$ 93,550
Non-interest revenue-net of provision for loan losses	195,429	6,193	43,124	244,746
Net revenues	\$ 254,621	\$ 38,588	\$ 45,087	\$ 338,296
Operating income (loss)	\$ 1,511	\$ 3,365	\$ (6,507)	\$ (1,631)
Six Months Ended June 30, 2001:				
Interest income-net of interest expense	\$ 111,568	\$ 74,605	\$ 4,495	\$ 190,668
Non-interest revenue-net of provision for loan losses	296,879	75,870	74,343	447,092
Net revenues	\$ 408,447	\$ 150,475	\$ 78,838	\$ 637,760
Operating income (loss)	\$ (12,550)	\$ 46,833	\$ (23,900)	\$ 10,383
Six Months Ended June 30, 2000:				
Interest income-net of interest expense	\$ 125,577	\$ 61,699	\$ 3,247	\$ 190,523
Non-interest revenue-net of provision for loan losses	464,509	5,621	94,343	564,473
Net revenues	\$ 590,086	\$ 67,320	\$ 97,590	\$ 754,996
Operating loss	\$ (14,518)	\$ (5,109)	\$ (7,270)	\$ (26,897)
As of June 30, 2001:				
Segment assets	\$6,184,821	\$12,690,075	\$425,275	\$19,300,171
As of September 30, 2000:				
Segment assets	\$7,805,843	\$ 9,027,185	\$484,409	\$17,317,437

No single customer accounted for greater than 10% of total revenues in the three and six months ended June 30, 2001 or 2000, respectively.

NOTE 15. ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS

Effective October 1, 2000, the Company adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. All derivatives, whether designated anew in hedging relationships on October 1, 2000 or not, are required to be recorded on the balance sheet at fair value. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, the effective portions of changes in the fair value of the derivative are recorded in other comprehensive income, referred to in this Form 10-Q as "OCI" and are recognized in the income statement when the hedged item affects earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

Interest Rate Risk

The Company uses derivatives to provide a cost- and capital-efficient way to manage the interest rate risk exposure of the Company by synthetically modifying the repricing or maturity characteristics of certain assets and liabilities and by locking in the rates of certain forecasted issuances of debt. The primary derivative instruments used include interest rate swaps, caps, and floors. The Company enters into interest rate swap agreements to assume fixed-rate interest payments in exchange for variable market-indexed interest payments. Depending on the hedge relationship, the effects of these agreements are to (a) convert adjustable rate liabilities to longer-term fixed rate liabilities, (b) convert long-term fixed rate assets to shorter-term adjustable rate assets or (c) reduce the variability of future changes in interest rates on forecasted issuances of debt. The net payments of these agreements are charged to either interest expense or interest income, depending on whether the agreement is designated to hedge an existing or forecasted liability or asset.

Fair Value Hedges

The Company uses a combination of interest rate swaps, caps and floors to substantially offset the change in value of certain fixed rate assets. In calculating the effective portion of the fair value hedges under SFAS No. 133, the change in the fair value of the hedge agreement is recognized currently in earnings, as is the change in value of the hedged item. Accordingly, the net difference or hedge ineffectiveness, if any, is recognized currently in non-operating income (expense), included in fair value adjustments of financial derivatives. Fair value hedge ineffectiveness resulted in a gain of \$0.3 million and \$1.8 million for the three and six months ended June 30, 2001, respectively.

During the three and six months ended June 30, 2001, multiple fair value hedges were derecognized and therefore hedge accounting was discontinued during the period. Changes in the fair value of these derivative instruments after the discontinuance of fair value hedge accounting are recorded in other revenue in the consolidated statement of operations, which totaled \$3.5 million and \$4.9 million of losses for the three and six months ended June 30, 2001, respectively. In addition, the Company recognized \$1.0 million and \$1.4 million of hedge ineffectiveness expense in fair value adjustments of financial derivatives included in non-operating expense for the period in which these hedge relationships were accounted for as fair value hedges during the three and six months ended June 30, 2001, respectively.

Cash Flow Hedges

Variable Rate Debt and Forecasted Issuances of Debt

The Company also uses interest rate swaps to hedge the variability of future cash flows associated with existing variable rate debt and forecasted issuances of debt. In respect to the variable rate debt currently on the balance sheet, the Company uses interest rate swaps to hedge the risk of changes in the benchmark rate (LIBOR), which impacts the amount of future payments to be made on the variable rate debt. In relation to the hedging of the forecasted issuance of debt, the Company utilizes interest rate swaps with a longer maturity than the underlying variable rate debt. The use of an interest rate swap contract with a longer maturity than the underlying debt allows the Company to hedge both the risk of changes in the benchmark rate (LIBOR) on our existing debt and the replacement of such debt upon maturity. These cash flow hedge relationships will be treated as effective hedges as long as the future issuances of debt remain probable and the hedges continue to meet the requirements of SFAS No. 133. The Company expects to hedge the forecasted issuance of debt over a maximum term of 7 years.

During the three and six months ended June 30, 2001, the Company reclassified \$9.5 million and \$10.9 million of derivative losses from OCI to realized gain (loss) on trading activity recorded in other revenue in the consolidated statement of operations for forecasted transactions that had become probable of not occurring.

The Company measures ineffectiveness for these cash flow hedges in accordance with SFAS No. 133. The ineffectiveness for the three and six months ended June 30, 2001 had no material impact on earnings.

In accordance with the Company's SFAS No. 133 accounting policy, all interest rate swap agreements in cash flow hedge relationships are recorded at fair value on the balance sheet. OCI is adjusted to the balance that reflects the effective portion of the change in the fair value of the derivative, net of tax. Gains or losses recorded in OCI are recognized in the income statement as the hedged items affect earnings.

Forward Commitments

The Company also uses forward commitments as cash flow hedges of the forecasted purchases or sales of securities. The Company measures ineffectiveness in accordance with the provisions of SFAS No. 133. The ineffectiveness for the three and six months ended June 30, 2001 had no material impact on earnings. For the three and six months ended June 30, 2001, there was no material impact in earnings for these forward commitments. The effective portion of the change in fair value of these forward commitments is recorded in OCI, net of tax. The amounts recorded to OCI will be recognized in the statement of operations as the hedged forecasted transactions affect earnings.

Foreign Currency Risk

Certain forecasted revenues and expenses are exposed to foreign currency risk. The Company's objective in hedging anticipated transactions is to mitigate the variability of operating and cash results from fluctuations in currency rates; hedging strategies are not speculative in nature. The Company primarily hedges against fluctuations in the foreign exchange rates of material, anticipated revenues/expenses of TIR which are denominated in non-functional currencies, typically the Japanese yen, the Euro, and the British pound. As the functional currency of TIR is the U.S. dollar and as TIR maintains customer accounts in over thirty currencies, current risk management policies allow authorized persons to enter into forward contracts and purchase options to hedge between 0-100% of exposures deemed material. Material exposures are assessed on the basis of cash flow projections prepared by TIR.

TIR uses forward contracts and purchase options to hedge a portion of forecasted revenue denominated in non-functional currencies for up to one year in the future. Forward contracts and purchase options are designated as cash flow hedging instruments.

In calculating the ineffective portion of the Company's hedge performance under SFAS No. 133, the Company excludes the time value component related to any option premiums paid and discounts or premiums on forward contracts and recognizes the amount in other income during the life of the contract. These amounts have not been material in the three or six months ended June 30, 2001. Hedge ineffectiveness related to the Company's foreign currency hedge instruments, determined in accordance with SFAS No. 133, had no impact on earnings for the three or six months ended June 30, 2001. No foreign exchange cash flow hedges were derecognized or discontinued during the three or six months ended June 30, 2001.

Derivative gains and losses included in OCI are reclassified into global and institutional revenues at the time forecasted revenue is recognized. During the three and six months ended June 30, 2001, derivative gains reclassified to revenue were not material. The Company estimates that net derivative gains related to foreign exchange hedges included in other comprehensive loss to be reclassified into earnings within the next twelve months will not be material.

Other Derivatives

The Company owns warrants to purchase shares of common stock of Wit (see Note 5). The adjustment to the fair value of these warrants of \$2.1 million and \$3.2 million is reflected in non-operating income for the three and six months ended June 30, 2001, respectively. The Company also holds 2.0 million unvested warrants to purchase shares of common stock of Wit received in connection with a strategic alliance agreement. Because vesting of these warrants is subject to future performance, their value will not be recognized until such criteria are met.

The Company engages in originating and selling mortgage loans as part of its mortgage banking business. As a result of mortgage banking activities, the Company records two different derivatives, Interest Rate Lock Commitments for mortgage loans that will be held for resale, commonly referred to as IRLCs, and forward sale agreements. Both the IRLCs and forward sale agreements are recorded on the balance sheet at fair value. Changes in the fair value of these derivatives are shown in the statement of operations as gains (losses) on loans held for sale, recorded in other revenue. Changes in the fair value of IRLCs resulted in a loss of \$4.6 million and \$5.6 million for the three and six months ended June 30, 2001, respectively. Changes in the fair value of forward sales agreements resulted in income of \$5.5 million and \$6.5 million for the three and six months ended June 30, 2001, respectively.

NOTE 16. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard, commonly referred to as SFAS, No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and other intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in

accordance with the new rules. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method of accounting and addresses the initial recognition and measurement of goodwill and intangible assets acquired in the business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of 2002. Upon adoption of SFAS No. 142, the Company will stop the amortization of goodwill with an estimated net carrying value of approximately \$416.6 million at December 31, 2001 and annual amortization expense of \$26.2 million that resulted from business combinations initiated prior to the adoption of SFAS No. 141. The Company will evaluate goodwill under the SFAS No. 142 transitional impairment test and has not yet determined whether or not there is an impairment loss. Any transitional impairment loss will be recognized as a change in accounting principle.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

*Statements in this document, other than statements of historical information, are forward-looking statements that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements, as well as other oral and written forward-looking statements made by us or on our behalf from time to time, including statements contained in our filings with the Securities and Exchange Commission, commonly referred to as the SEC, and our reports to shareowners, involve known and unknown risks and other factors which may cause our actual results in future periods to differ materially from those expressed in any forward-looking statements. Any such statement is qualified by reference to the risks and factors discussed below under the headings "Liquidity and Capital Resources" and "Risk Factors," as well as in our filings with the SEC, which are available from the SEC or which you may request from us. We caution that the risks and factors discussed below and in such filings are not exclusive. We do not undertake to update any forward-looking statement that may be made from time to time by or on behalf of E*TRADE. You are urged to carefully review and consider the various disclosures in this report and in our other reports filed with the SEC, including our Annual Report on Form 10-K/A as filed with the SEC on November 22, 2000, that attempt to advise you of certain risks and factors that may affect our business. You are cautioned not to place undue reliance on these forward-looking statements to reflect events or circumstances occurring after the date hereof. The following should be read in conjunction with our consolidated financial statements and notes to these consolidated financial statements.*

Highlights for the Six Months Ended June 30, 2001

Quarter Ended March 31, 2001:

- E*TRADE acquired LoansDirect Inc., an online mortgage originator, in a purchase acquisition.
- E*TRADE's common stock listing moved to the New York Stock Exchange.
- E*TRADE changed its fiscal year end from September 30 to December 31st.

Quarter Ended June 30, 2001:

- E*TRADE entered into an agreement to acquire WebStreet, Inc., an online brokerage firm, in a purchase acquisition.
- E*TRADE announced the pricing of a \$325 million private placement of its 6³/4% convertible subordinated notes due in May 2008.
- E*TRADE continued its international expansion with the launch of E*TRADE Hong Kong and E*TRADE Israel.
- E*TRADE opened the E*TRADE Center in New York City, New York, a financial service superstore designed to give consumers value added financial services and educational content in a high technology, interactive environment.
- E*TRADE and Target extended their co-marketing alliance with plans for 20 new E*TRADE Zones and over 1,000 ATMs.
- E*TRADE launched E*TRADE Mortgage, a major integration milestone following its acquisition of LoansDirect, Inc.
- E*TRADE Bank acquired 15,000 customer accounts with deposits valued at \$389.7 million in a transaction with Advanta National Bank, a subsidiary of Advanta Corporation.

Results of Operations

Key Performance Indicators

The following tables set forth several key performance indicators which management utilizes in measuring our performance and in explaining the results of our operations for the comparative three and six months presented and as of June 30, 2001 and September 30, 2000 (dollars in thousands except cost per new account, average commission per domestic brokerage transaction and rebate income per domestic brokerage transaction):

	Three Months Ended June 30,			Six Months Ended June 30,		
	2001	2000	Percentage Change	2001	2000	Percentage Change
Net new domestic brokerage accounts	65,610	270,708	(76)%	176,646	817,881	(78)%
Net new banking accounts	30,039	51,998	(42)%	72,187	91,947	(21)%
Net new global and institutional accounts	7,840	10,854	(28)%	20,768	34,413	(40)%
Total net new accounts	103,489	333,560	(69)%	269,601	944,241	(71)%

Cost per new account	\$ 232	\$ 291	(20)%	\$ 328	\$ 269	22 %
Total domestic brokerage transactions	7,148,235	10,491,288	(32)%	15,233,084	24,733,340	(38)%
Daily average domestic brokerage transactions	113,464	166,528	(32)%	121,865	196,296	(38)%
Average commission per domestic brokerage transaction	\$ 13.23	\$ 15.13	(13)%	\$ 13.44	\$ 15.55	(14)%
Rebate income per domestic brokerage transaction	\$ 2.06	\$ 1.79	15 %	\$ 2.36	\$ 1.92	23 %

	June 30, 2001	September 30, 2000	Percentage Change
Active domestic brokerage accounts	3,289,014	2,951,946	11 %
Active banking accounts	434,804	288,073	51 %
Active global and institutional accounts	104,792	75,416	39 %
Total active accounts at period end	3,828,610	3,315,435	15 %
Total customer households end of period	2,738,838	Not Available	N/A
Average assets per household	\$ 19,513	Not Available	N/A
Total assets in domestic brokerage accounts	\$44,553,710	\$ 59,901,277	(26)%
Total deposits in banking accounts	7,687,006	4,630,068	66 %
Total assets in global and institutional accounts	1,202,718	1,348,672	(11)%
Total assets/deposits in customer accounts at period end	\$53,443,434	\$ 65,880,017	(19)%

For purposes of the tables above:

- A domestic or global brokerage account is included as an active account if the account has a positive asset balance, or if a trade has been made in the account in the past six months or if the account was opened in connection with a corporate employee stock benefit program. Customers may have separate or multiple accounts for each relationship they maintain with us, including separate or multiple brokerage and banking accounts.
- A banking account is included as an active account if a customer has made an initial deposit and the account is not considered abandoned or dormant under applicable Federal and State laws and the account has not been closed.
- Net new accounts is equal to the number of accounts opened during the applicable period that qualify as active accounts less the number of accounts deactivated due to customer attrition or because the account no longer meets the definition of an active account during the reported period.
- A household is a collection of active accounts, as defined above, which have a matching address and last name.

The following table sets forth the components of both gross and net revenues and percentage change information related to certain items on our Consolidated Statements of Operations for the periods indicated (dollars in thousands):

	Three Months Ended June 30,		Percentage Change	Six Months Ended June 30,		Percentage Change
	2001	2000		2001	2000	
Transaction revenues:						
Commission	\$ 94,567	\$ 161,449	(41)%	\$ 204,723	\$ 387,244	(47)%
Order flow	14,697	18,745	(22)%	35,903	47,546	(24)%
Total transaction revenues	109,264	180,194	(39)%	240,626	434,790	(45)%
Interest income:						
Brokerage-related activities	80,718	122,750	(34)%	181,463	255,991	(29)%
Banking-related activities	217,797	135,641	61 %	434,482	245,982	77 %
Total interest income	298,515	258,391	16 %	615,945	501,973	23 %
Global and institutional	37,047	40,577	(9)%	73,888	90,253	(18)%
Other	71,185	24,949	185 %	135,677	41,660	226 %
Gross revenues	516,011	504,111	2 %	1,066,136	1,068,676	— %
Interest expense:						
Brokerage-related activities	(26,665)	(61,650)	(57)%	(65,400)	(127,222)	(49)%
Banking-related activities	(179,511)	(103,191)	74 %	(359,877)	(184,228)	95 %
Total interest expense	(206,176)	(164,841)	25 %	(425,277)	(311,450)	37 %
Provision for loan losses	(1,656)	(974)	70 %	(3,099)	(2,230)	39 %
Net revenues	\$ 308,179	\$ 338,296	(9)%	\$ 637,760	\$ 754,996	(16)%

Gross revenues increased 2% and remained flat in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively, and net revenues decreased 9% and 16% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The decreases in net revenues are mainly due to decreases in our brokerage-related activities, including transaction revenues and interest income. The Nasdaq composite index reached a record high in March 2000, compared to a dramatic decline through the period ended June 30, 2001, losing approximately 57% of its value. The sharp decline in the value of publicly traded securities has significantly impacted the total assets in our domestic brokerage accounts, which declined by 21% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. Gross revenues consist principally of commission revenues from domestic retail brokerage transactions, payments for order flow, interest income, institutional transaction execution fees, international brokerage-related transaction revenue and, to a lesser degree, revenue from services, gains on the sale of loans and securities, and royalty revenues.

Transaction Revenues

Transaction revenues decreased 39% and 45% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The decreases are primarily due to the stock market downturn experienced since September 2000. Transaction revenues consist of commission revenues from domestic retail brokerage transactions and payments for order flow.

Commission revenues, which are earned as customers execute domestic securities trades, decreased 41% and 47% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. These revenues are primarily affected by domestic brokerage transaction volume and the average commission per domestic brokerage transaction. Daily average domestic brokerage transactions and total domestic brokerage transactions decreased 32% and 38% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively, largely reflective of the market downturn. The average commission per domestic transaction decreased from \$15.13 and \$15.55 in the three and six months ended June 30, 2000, respectively, to \$13.23 and \$13.44 in the three and six months ended June 30, 2001, respectively. The decline in average commission per domestic brokerage transaction is primarily a result of promotional activities and the mix of revenue generating transactions, reflecting a higher percentage of trading by Power E*TRADE customers, our high volume traders. During the market downturn, the volume of transactions from our Power E*TRADE customers has declined less than the volume from our other customers. Power E*TRADE customers pay commissions as low as \$4.95 per equity transaction compared with other customers who pay commissions of \$14.95 or \$19.95 per equity transaction.

Revenue from order flow is comprised of rebate income from various market makers and market centers for processing transactions through them. We use other broker-dealers to execute our customers' orders and have derived a significant portion of our transaction revenues from these broker-dealers for such order flow. This practice of receiving payment for order flow is widespread in the securities industry. Under applicable SEC regulations, receipt of these payments requires disclosure of such payments by us to our customers. Impacting revenues from order flow, the listed marketplace, with the exception of the Nasdaq, implemented the move from fractional based trading to decimals, referred to in this Form 10-Q as decimalization, in January 2001, and the Nasdaq initiated decimalization in March 2001. Revenues from order flow decreased 22% and 24% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. This decrease reflects a decrease in rebates per equity share which decreased approximately 57% and 9% in the three and six months ended June 30, 2001, respectively, as compared to the prior year periods, primarily resulting from the implementation of decimalization of Nasdaq listed securities, from which a majority of our order flow revenue is derived, which has decreased market maker and market center spreads. The decrease has been partially offset by the acceptance of option order flow beginning in October 2000. Option order flow revenue recognized in the three and six months ended June 30, 2001 contributed to the 15% and 23% increase in the rebate per domestic brokerage transaction in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. We cannot be certain that rebates per transaction will continue at the same levels in future periods.

With the relatively recent implementation of decimalization, certain market makers have reduced payments for order flow, others have announced plans to reduce payments for order flow, and others continue to take a "wait and see" approach. Going forward, we expect revenue from order flow to continue to decrease due to decimalization; however, at this time, we are unable to quantify the future impact on net revenues. Further, there can be no assurance that we will be able to continue our present relationships and terms for such payments for order flow. In addition, there can be no assurance that payments for order flow will continue to be permitted by the SEC, the NASDR or other regulatory agencies, courts or governmental units. Loss of any or all of these revenues could harm our business. See "Item 2. Risk factors—Restrictions on the ability of, or decreased willingness of, third parties to make payments for order flow or potential payments by us to third parties for handling orders could reduce our profitability."

Overall, transaction revenues as a percentage of net revenues have decreased from 53% and 58% in the three and six months ended June 30, 2000, respectively, to 35% and 38% in the three and six months ended June 30, 2001 due to our efforts to diversify revenue streams, and also due in part to the market downturn.

Interest Income and Expense

Interest income from brokerage-related activities is comprised of interest earned by our brokerage subsidiaries on credit extended to customers to finance their purchases of securities on margin and fees on customer assets invested in money market accounts. Interest expense from brokerage-related activities is comprised of interest paid to customers on certain credit balances, interest paid to banks and interest paid to other broker-dealers through our brokerage subsidiary's stock loan program. Interest income from banking-related activities reflects interest earned on assets, consisting primarily of loans receivable and mortgage-backed securities. Interest expense from banking-related activities is comprised of interest-bearing banking liabilities that include customer deposits, advances from the FHLB, and other borrowings.

Brokerage interest income decreased 34% and 29% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The decrease in brokerage interest income primarily reflects the decrease in average customer margin balances, which decreased by 60% and 51% in the three and six months ended June 30, 2001, from the comparable periods in 2000, respectively, lowering customer margin interest from \$101.2 million and \$192.7 million in the three and six months ended June 30, 2000 to \$41.4 million and \$104.1 million in the three and six months ended June 30, 2001, respectively. The dramatic decline in the equity markets since March 2000 has reduced borrowing on margin by customers as a means of leveraging their investments. Partially offsetting this decrease are stock borrow balances and customer money market fund balances. Stock borrow balances have increased 188% and 175% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively, which has increased stock borrow interest from \$9.0 million and \$16.3 million in the three and six months ended June 30, 2000, respectively, to \$17.7 million and \$36.2 million in the three and six months ended June 30, 2001, respectively. Customer money market fund balances increased 18% and 22% in the three and six months ended June 30, 2001, from the comparable periods in 2000, respectively, which has increased fees earned on customer assets invested in money market funds from \$14.1 million and \$27.1 million in the three and six months ended June 30, 2000, respectively, to \$16.4 million and \$32.0 million in the three and six months ended June 20, 2001, respectively. Brokerage interest expense decreased 57% and 49% in the three and six months ended June 30, 2001 from the comparable periods in 2000,

respectively. The decrease in brokerage interest expense primarily reflects a decrease in average stock loan balances, which decreased 38% and 40% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively, resulting in a decrease in stock loan interest expense from \$55.3 million and \$113.8 million in the three and six months ended June 30, 2000, respectively, to \$22.0 million and \$55.1 million in the three and six months ended June 30, 2001, respectively. Net brokerage interest income decreased 12% and 10% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively, primarily due to the effects of the market downturn. This decrease harms our net revenues and operating income. The following table sets forth the increases and decreases in average customer margin balances, average customer money market fund balances, average stock borrow balances, average stock loan balances, and average customer credit balances for the three and six months indicated (dollars in millions):

	Three Months Ended June 30,			Six Months Ended June 30,		
	2001	2000	Percentage Change	2001	2000	Percentage Change
Average customer margin balances	\$2,014	\$5,048	(60)%	\$2,437	\$4,990	(51)%
Average customer money market fund balances	\$8,634	\$7,303	18 %	\$8,615	\$7,038	22 %
Average stock borrow balances	\$1,954	\$ 679	188 %	\$1,741	\$ 634	175 %
Average stock loan balances	\$2,321	\$3,756	(38)%	\$2,457	\$4,094	(40)%
Average customer credit balances	\$1,168	\$1,280	(9)%	\$1,180	\$1,308	(10)%

Banking interest income increased 61% and 77% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. Increases in banking interest income reflect overall growth in our banking segment including increases in the average interest-earning banking asset balances, partially offset by a decline in the average yield. Average interest-earning banking assets increased 77% and 89% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The average yield on interest-earning banking assets decreased to 7.14% and 7.30% in the three and six months ended June 30, 2001 from 7.86% and 7.82% in the three and six months ended June 30, 2000, respectively. Average retail deposits in banking accounts increased 98% and 105% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. Banking interest expense increased 74% and 95% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The increase in banking interest expense reflects an increase in the average interest-bearing banking liability balances coupled with an increase in the average cost of the borrowings. Average interest-bearing banking liability balances increased 76% and 90% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The average cost of borrowings decreased to 6.26% and increased to 6.44% in the three and six months ended June 30, 2001, respectively, from 6.33% and 6.23% in the three and six months ended June 30, 2000, respectively. The decrease in the average net interest spread from 1.53% and 1.59% in the three and six months ended June 30, 2000, respectively, to 0.88% and 0.86% in the three and six months ended June 30, 2001, respectively, is primarily a result of the increased leverage of the Bank coupled with an increase in the costs of retail deposits.

The following table presents average balance data and income and expense data for our banking operations and the related interest yields and rates for the three and six months ended June 30, 2001 and 2000. The table also presents information with respect to net interest margin, an indicator of profitability. Another indicator of profitability is net interest spread, which is the difference between the weighted average yield earned on interest-earning banking assets and weighted average rate paid on interest-bearing banking liabilities (dollars in thousands):

	Three Months Ended June 30, 2001			Three Months Ended June 30, 2000		
	Average Balance	Interest Income/ Expense	Average Annualized Yield/Cost	Average Balance	Interest Income/ Expense	Average Annualized Yield/Cost
Interest-earning banking assets:						
Loans receivable, net	\$ 6,787,799	\$127,975	7.54%	\$3,374,777	\$ 68,620	8.13%
Interest-bearing deposits	213,246	2,855	5.37%	45,721	737	6.48%
Mortgage-backed and related available-for-sale securities	3,879,478	63,431	6.54%	3,187,770	60,992	7.65%
Available-for-sale investment securities	1,190,537	21,938	7.37%	223,459	3,873	7.13%
Investment in FHLB stock	65,175	1,049	6.46%	69,414	1,341	7.77%
Trading securities	70,028	549	3.14%	6,077	78	5.11%
Total interest-earning banking assets	12,206,263	\$217,797	7.14%	6,907,218	\$135,641	7.86%
Non-interest-earning banking assets	534,732			288,330		
Total banking assets	\$12,740,995			\$7,195,548		
Interest-bearing banking liabilities:						
Retail deposits	\$ 6,919,219	\$107,441	6.22%	\$3,491,184	\$ 53,547	6.12%
Brokered callable certificates of deposit	26,628	384	5.79%	91,730	1,478	6.46%
FHLB advances	1,281,064	20,334	6.28%	1,354,077	21,694	6.34%
Other borrowings	3,278,114	51,352	6.20%	1,615,762	26,472	6.48%
Total interest-bearing banking liabilities	11,505,025	\$179,511	6.26%	6,552,753	\$103,191	6.33%
Non-interest bearing banking liabilities	514,466			161,966		
Total banking liabilities	\$12,019,491			\$6,714,719		
Total banking shareowner's equity	721,504			480,829		
Total banking liabilities and shareowner's equity	\$12,740,995			\$7,195,548		
Excess of interest-earning banking assets over interest-bearing banking liabilities/net interest income	\$ 701,238	\$ 38,286		\$ 354,465	\$ 32,450	
Net interest spread			0.88%			1.53%
Net interest margin (net yield on interest-earning banking assets)			1.26%			1.88%

Ratio of interest-earning banking assets to interest-bearing banking liabilities	106.10%	105.41%
Return on average total banking assets	0.31%	0.07%
Return on average net banking assets	5.44%	0.07%
Equity to total banking assets	5.97%	6.68%

☒ Ratios calculated by excluding our Employee Stock Ownership Plan and merger related costs of none and \$0.2 million in the three months ended June 30, 2001 and 2000.

	Six Months Ended June 30, 2001			Six Months Ended June 30, 2000		
	Average Balance	Interest Income/ Expense	Average Annualized Yield/Cost	Average Balance	Interest Income/ Expense	Average Annualized Yield/Cost
Interest-earning banking assets:						
Loans receivable, net	\$ 6,252,358	\$239,317	7.66%	\$3,076,196	\$124,739	8.11%
Interest-bearing deposits	191,440	5,820	6.13%	75,325	2,187	5.82%
Mortgage-backed and related available-for-sale securities	4,338,892	148,869	6.86%	2,863,613	108,998	7.61%
Available-for-sale investment securities	953,966	35,102	7.36%	208,864	7,229	7.13%
Investment in FHLB stock	74,216	2,539	6.90%	61,421	2,370	7.74%
Trading securities	99,250	2,835	5.71%	14,990	459	6.13%
Total interest-earning banking assets	11,910,122	\$434,482	7.30%	6,300,409	\$245,982	7.82%
Non-interest-earning banking assets	405,417			261,088		
Total banking assets	\$12,315,539			\$6,561,497		
Interest-bearing banking liabilities:						
Retail deposits	\$ 6,554,078	\$207,509	6.38%	\$3,200,676	\$ 96,723	6.06%
Brokered callable certificates of deposit	58,956	1,809	6.19%	91,783	2,961	6.47%
FHLB advances	1,452,242	47,933	6.56%	1,205,357	38,010	6.24%
Other borrowings	3,210,668	102,626	6.36%	1,436,687	46,534	6.41%
Total interest-bearing banking liabilities	11,275,944	\$359,877	6.44%	\$5,934,503	\$184,228	6.23%
Non-interest bearing banking liabilities	352,735			137,380		
Total banking liabilities	\$11,628,679			\$6,071,883		
Total banking shareowner's equity	686,860			489,614		
Total banking liabilities and shareowner's equity	\$12,315,539			\$6,561,497		
Excess of interest-earning banking assets over interest-bearing banking liabilities/net interest income	\$ 634,178	\$ 74,605		\$ 365,906	\$ 61,754	
Net interest spread			0.86%			1.59%
Net interest margin (net yield on interest-earning banking assets)			1.26%			1.97%
Ratio of interest-earning banking assets to interest-bearing banking liabilities			105.62%			106.17%
Return on average total banking assets			0.37%			0.20%
Return on average net banking assets			6.60%			2.64%
Equity to total banking assets			5.97%			6.46%

☒ Ratios calculated by excluding Employee Stock Ownership Plan and merger related costs of \$0.2 million and \$16.7 million in the six months ended June 30, 2001 and 2000.

Global and Institutional

Global and institutional revenues decreased 9% and 18% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. For the three and six months ended June 30, 2001, global and institutional revenues are comprised primarily of revenues from institutional operations of \$31.4 million and \$62.6 million, respectively, as well as brokerage-related transaction revenue from our international subsidiaries of \$5.6 million and \$11.3 million, respectively. The overall decrease in global and institutional revenues is primarily attributable to a slowdown in the institutional business that was consistent with market conditions in the three and six months ended June 30, 2001.

Other

Other revenues increased 185% and 226% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. Of these

increases, \$28.8 million and \$46.1 million are due to revenues generated from purchase acquisitions made subsequent to April 2000, \$7.0 million and \$25.4 million are due to net gains on available for sale and trading securities and gains on sales of bank loans primarily resulting from the realignment of our Bank asset portfolio, and \$9.7 million and \$18.1 million are due to the implementation of a \$15 quarterly maintenance fee for low-balance, inactive accounts which was instituted in December 2000, in the three and six months ended June 30, 2001, respectively. For purposes of the quarterly maintenance fee, an inactive account is one in which there have been less than two commissionable trades in the six months prior to quarter end. In future periods, net gains on investments and gains on sales of bank loans may fluctuate. We expect to continue our policy of assessing maintenance fees for low-balance, inactive accounts. Revenues from our purchase acquisitions will fluctuate and may decrease. Purchase acquisitions included the acquisitions of E*TRADE Access in May 2000 and LoansDirect, Inc. in February 2001, merged into and renamed E*TRADE Mortgage. Also included in other revenues are Business Solutions Group revenue, mutual fund revenues, and brokerage and banking-related fees for services, which in the aggregate have remained flat in the three and six months ended June 30, 2001 as compared to the respective prior year periods.

Loans Receivable and Provision for Loan Losses

The provision for loan losses recorded reflects increases in our allowance for loan losses based upon management's review and assessment of the risk in our loan portfolio. The provision for loan losses increased 70.1% and 39.0% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The increase in the provision for loan losses primarily reflects the growth in and composition of our banking loan portfolio. As of June 30, 2001 and September 30, 2000, the total loan loss allowance was \$15.1 million, or 0.22% of total loans outstanding, and \$10.9 million, or 0.26% of total loans outstanding, respectively. As summarized below, as of June 30, 2001, the loan loss allowance was \$15.1 million, or 95.9% of total non-performing loans of \$15.7 million. As of September 30, 2000, the loan loss allowance was \$10.9 million, or 90.7% of total non-performing loans of \$12.0 million.

The following table presents information concerning our banking loan portfolio as of June 30, 2001 and September 30, 2000, in dollar amounts, by type of loan. Subsequent to September 30, 2000 and consistent with our loan diversification strategy, we began purchasing loans secured by automobiles, leading to the significant increase in the percentage of loans backed by autos shown as of June 30, 2001 (dollars in thousands):

	June 30, 2001	Percentage	September 30, 2000	Percentage
Real estate loans:				
One- to four-family	\$4,501,851	64.8%	\$4,123,684	97.6%
Multi-family	192	0.0%	203	0.0%
Commercial	2,480	0.0%	2,717	0.1%
Mixed-use	693	0.0%	503	0.0%
Consumer and other loans:				
Autos	782,125	11.3%	—	—
Home equity lines of credit and second mortgage loans	8,185	0.1%	4,042	0.1%
Lease financing	—	0.0%	82	0.0%
Other	36,225	0.5%	224	0.0%
Loans held for sale	1,615,796	23.3%	95,400	2.2%
Total loans	<u>6,947,547</u>	<u>100.0%</u>	<u>4,226,855</u>	<u>100.0%</u>
Less unamortized discounts, net	(20,527)		(43,171)	
Less allowance for doubtful accounts	(15,080)		(10,930)	
Total	<u>\$6,911,940</u>		<u>\$4,172,754</u>	

The following table presents information about our non-accrual loans and Real Estate Owned ("REO") as of the periods indicated. The Company had no Troubled Debt Restructurings ("TDRs") as of June 30, 2001 and September 30, 2000. (dollars in thousands):

	June 30, 2001	September 30, 2000
Loans accounted for on a non-accrual basis:		
Real estate loans:		
One- to four-family	\$15,162	\$11,391
Commercial	352	657
Total real estate loans	<u>\$15,514</u>	<u>\$12,048</u>
Home equity lines of credit and second mortgage loans	81	—
Autos	137	—
Total non-performing loans	<u>15,732</u>	<u>12,048</u>
REO: One- to four-family	641	850
Total non-performing assets	<u>\$16,373</u>	<u>\$12,898</u>
Total non-performing assets as a percentage of total loans	<u>0.24%</u>	<u>0.31%</u>
Total non-performing assets as a percentage of total banking assets	<u>0.13%</u>	<u>0.14%</u>
Total loan loss allowance as a percentage of total non-performing loans	<u>95.86%</u>	<u>90.72%</u>
Total non-performing loans as in percentage of total loans	<u>0.23%</u>	<u>0.29%</u>

Activity in the allowance for loan losses is summarized as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Allowance for loan losses, beginning of the period	\$13,821	\$8,795	\$12,565	\$7,647
Provision for loan losses	1,656	974	3,099	2,231
Charge-offs, net	(397)	(47)	(584)	(156)
Allowance for loan losses, end of period	\$15,080	\$9,722	\$15,080	\$9,722

Operating Expenses

The following table sets forth the components of cost of services and operating expenses and percentage change information for the three and six months ended June 30, 2001 and 2000 (dollars in thousands):

	Three Months Ended June 30,		Percentage Change	Six Months Ended June 30,		Percentage Change
	2001	2000		2001	2000	
Cost of services	\$150,458	\$128,582	17 %	\$292,893	\$264,161	11 %
Cost of services as a percentage of net revenues	49%	38%		46%	35%	
Operating expenses:						
Selling and marketing	\$ 55,399	\$117,324	(53)%	\$149,097	\$297,929	(50)%
Technology development	23,420	33,792	(31)%	45,701	77,127	(41)%
General and administrative	61,906	52,188	19 %	122,148	104,739	17 %
Amortization of goodwill and other intangibles	9,022	6,908	31 %	17,021	12,205	39 %
Acquisition-related expenses	517	1,133	(54)%	517	25,732	(98)%
Total operating expenses	\$150,264	\$211,345	(29)%	\$334,484	\$517,732	(35)%

Cost of Services

Cost of services as a percentage of net revenues was 49% and 46% in the three and six months ended June 30, 2001, respectively, and 38% and 35% in the three and six months ended June 30, 2000, respectively. The increase in cost of services as a percentage of net revenues is primarily a result of increased headcount due to the acquisitions of E*TRADE Access in May 2000 and E*TRADE Mortgage in February 2001, and an increase in amortization expense related to internally developed software as significant projects were placed into production in November 2000, coupled with the decrease in net revenues from the prior year comparable periods. Cost of services increased 17% and 11% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. Cost of services includes expenses related to our brokerage clearing operations, customer service activities, web site content costs, systems maintenance, and amortization expenses related to internally developed and purchased software. The increase in cost of services was primarily due to increased activity in our banking and global and institutional business segments, where active customer accounts have increased 95% and 70%, respectively, from June 30, 2000 to June 30, 2001. Growth in our banking and international subsidiaries combined with investment in our asset gathering business resulted in approximately \$24.4 million and \$39.6 million in the three and six months ended June 30, 2001, respectively, of additional costs incurred. These increases reflect personnel costs related to the purchase acquisitions of E*TRADE Access in May 2000 and E*TRADE Mortgage in February 2001. Further contributing to the increase in cost of services, we have incurred an increase in expenses related to the amortization of capitalized software of \$7.7 million and \$12.5 million in the three and six months ended June 30, 2001, respectively, as compared to prior periods. These increases were partially offset by savings in the brokerage segment to meet lower transaction and inquiry volumes, productivity enhancements through improved training and call reducing initiatives, reduced costs of confirmations because of lower transaction volumes, and an increase in the electronic delivery of statements and confirms. Cost of services has not decreased at the same level as transaction revenues because of the need to maintain an acceptable level of customer service across an account base that continues to grow and the need to service a wider range of product offerings. Looking forward, we plan to continue to identify and implement cost savings strategies in this area, including the full integration of our bank and brokerage customer service and the implementation of a tiered customer service strategy across the organization which will include improved interactive voice response call servicing and a tier-focused automated call routing system.

Selling and Marketing

Selling and marketing expenses decreased 53% and 50% in the three and six months ended June 30, 2001 from the comparable prior year periods, respectively. The selling and marketing expenditures reflect expenditures for advertising placements, creative development and collateral materials resulting from a variety of advertising campaigns directed at expanding brand identity, growing the customer base and increasing market share. Selling and marketing expenditures also include selling efforts in support of our global and institutional business segment and costs to sell products of our asset gathering business segment. The decreases in selling and marketing expenses are primarily due to reductions in customer acquisition spending, including advertising, online and direct mailing and promotional activities, which are expected to remain at lower than prior year levels. Cost per new account decreased from \$291 in the three months ended June 30, 2000 to \$232 in the three months ended June 30, 2001, due to our efforts to spend marketing dollars more efficiently by cross selling banking services to our brokerage customers. Going forward, our focus will be on developing current customer households, reviewing metrics such as value per household, assets per household and share of wallet instead of cost per new account. We expect that marketing expenditure levels will be significantly lower than during the fiscal year ended September 30, 2000. If general market conditions improve, we will explore the possibility of increasing our spending. We believe that our reduction in selling and marketing expenditures will not significantly impact our competitive position because substantial investment in marketing efforts has already been made to build a strong brand identity and because we are focusing marketing and sales resources on cross

selling our services to our existing customer base, which is a less expensive way to generate and maintain business.

Technology Development

Technology development expenses decreased 31% and 41% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. The expense for technology development was incurred to enhance our existing product offerings, including enhancements to E*TRADE's web site and development of Customer Relationship Management, referred to in this Form 10-Q as CRM, capabilities. Technology development costs in the three and six months ended June 30, 2001 have decreased as compared to the prior year periods. Development efforts were refocused on fewer projects with higher anticipated benefits resulting in a reduction in the use of outside contractors. Certain development project costs were capitalized from the date of technological feasibility through the implementation date. As projects, such as our CRM projects, are implemented, the costs of development are amortized. During the six months ended June 30, 2001, significant phases of our CRM project were implemented. With management's continuing focus on cost savings initiatives, technology development expenses will remain at least flat over those experienced during the three months ended June 30, 2001. The reduction in technology development spending is not expected to harm our ability to operate competitively, as improvements implemented to date provide us with features and sufficient excess capacity to meet currently anticipated needs of the business.

General and Administrative

General and administrative expenses increased 19% and 17% in the three and six months ended June 30, 2001 from the comparable periods in 2000, respectively. General and administrative expenses increased primarily as a result of increased costs related to the growth of our banking segment, which includes the operations of E*TRADE Access and E*TRADE Mortgage. In addition, we incurred a \$9.8 million compensation charge in January 2001. Of this amount, approximately \$9.6 million is non-recurring and is related to the vesting of funds contributed to our Supplemental Executive Retirement Plan. Looking forward, we expect that general and administrative expenses will remain at least flat with the three months ended June 30, 2001, allowing for possible reductions as we integrate our business acquisitions, continue our efforts to re-engineer and reorganize our business to realize operating efficiencies, and review expenses in response to current and future market conditions. We will continue to actively manage our headcount with a focus on responsible hiring, attrition, efficient use of our associates and performance-based management.

Amortization of Goodwill and Other Intangibles

Amortization of goodwill and other intangibles was \$9.0 million and \$17.0 million and \$6.9 million and \$12.2 million in the three and six months ended June 30, 2001 and 2000, respectively. The significant increase in the amortization of goodwill and other intangibles primarily consists of the amortization of goodwill and other intangibles related to the purchase acquisition of E*TRADE Access in May 2000, the acquisition of E*TRADE Germany AG, which was acquired during the three months ended December 31, 2000, and the acquisition of E*TRADE Mortgage, which was acquired in February 2001, respectively. Goodwill is amortized over 5 to 20 years. Upon our adoption of SFAS No. 142, *Goodwill and Other Intangible Assets*, on January 1, 2002, we will discontinue the amortization of goodwill subject to the new rules. See "Recent Accounting Pronouncements." Other intangibles are not significant. We acquired WebStreet, Inc. on June 30, 2001 and have preliminarily allocated the excess of the purchase price to active accounts purchased. We will amortize approximately \$35.0 million in related capitalized costs over seven years using an accelerated method.

Acquisition-Related Expenses

Acquisition-related expenses were \$0.5 million in the three and six months ended June 30, 2001, and \$1.1 million and \$25.7 million in the three and six months ended June 30, 2001 and 2000, respectively, and primarily represent transaction costs associated with acquisitions accounted for as poolings of interests.

Non-Operating Income (Expense)

Corporate interest income was \$5.2 million and \$11.0 million in the three and six months ended June 30, 2001, respectively, and \$5.6 million and \$9.2 million in the three and six months ended June 30, 2000, respectively. Corporate interest income includes interest income earned on corporate investment balances, restricted cash balances, and related party notes. The increase in corporate interest income was primarily due to interest income earned on related party notes, which were entered into during the period from March 2000 through June 2001 and the increase in our corporate investment balances from \$248.0 million as of June 30, 2000 to \$677.9 million as of June 30, 2001.

Corporate interest expense was \$12.8 million and \$24.0 million in the three and six months ended June 30, 2001, respectively, and \$11.0 million and \$18.1 million in the three and six months ended June 30, 2000, respectively. Corporate interest expense in the three months ended June 30, 2001 and 2000 primarily relates to interest expense resulting from the issuance of \$650 million in convertible subordinated notes in February and March 2000 and the issuance of \$325 million in convertible subordinated notes in May 2001.

Realized losses on investments were \$13.0 million and \$15.6 million in the three and six months ended June 30, 2001, respectively, and realized gains on investments were \$24.4 million and \$35.3 million in the three and six months ended June 30, 2000, respectively. For the three months ended June 30, 2001, losses on investments included a \$10.6 million impairment write down on several publicly traded equity securities and two of our proprietary mutual funds, an approximate \$0.6 million realized loss on our seed investments in the E*TRADE Global Titan Fund, E*TRADE Financial Sector Index Fund and the E*TRADE Russell 2000 Index Fund, and a \$1.8 million realized loss on the sale of publicly traded equity securities. In the prior year quarter, gain on the sale of investments was recorded as a result of the sales of publicly traded equity securities. For the six months ended June 30, 2001, loss on investment included an additional loss of \$2.5 million that was realized on the sale of a publicly traded equity security. In the six months ended June 30, 2000, a \$35.3 million gain on investments was recorded as a result of the sales of publicly traded equity securities.

Equity in losses of investments was \$1.8 million and \$5.2 million in the three and six months ended June 30, 2001, respectively, and \$1.4 million and \$2.2 million in the three and six months ended June 30, 2000, respectively. The increase in the losses is due primarily to an increase in losses recorded from our investment in Wit Soundview Group, Inc., accounted for under the equity method, partially offset by income recorded from our equity investment in E*TRADE Japan KK. For the quarter ended June 30, 2001, Wit reported a net loss of \$267.8 million, including a goodwill impairment charge of \$249.7 million related to its acquisition of E*Offering. Our original carrying value for our investment in Wit common stock did not include any amount for the goodwill originally recorded by Wit in its acquisition of E*Offering because the carrying value was based on the book value of E*Offering. Accordingly, we

would not recognize any portion of Wit's impairment charge in connection with recording our proportionate share of Wit's losses under the equity method of accounting. Due to certain events in July 2001, we believe that we no longer have significant influence over Wit. Accordingly, we will discontinue the use of the equity method of accounting for our holdings in Wit effective for the quarter ended September 30, 2001 and we will account for our investment in Wit under the cost method. At June 30, 2001, the market value of the Wit securities which we hold was approximately \$22.1 million compared with our carrying value of \$39.4 million. The market price of Wit declined below our carrying value during February 2001; should the market price of Wit remain below its carrying value through September 30, 2001, we believe that this will indicate that the decline in value is other than temporary, requiring a write down of this investment to its then fair market value.

In the three and six months ended June 30, 2001 and 2000, we recorded unrealized losses on venture funds of \$9.0 million and \$20.6 million and \$3.5 million and \$18.1 million, respectively, primarily due to our participation in Sofbank Capital Partners, L.P., E*TRADE eCommerce Fund, L.P. and E*TRADE eCommerce Fund II, L.P. These changes represent market fluctuations on public investments held by the funds and changes in the estimated value of their non-public investments.

In the three and six months ended June 30, 2001, we recorded a loss of \$1.7 million and \$1.4 million, respectively, for the fair value adjustments of financial derivatives. In the three months ended June 30, 2001, the amount represents a \$2.1 million loss on the valuation of warrants, offset by a \$0.4 million gain for the ineffective portions of changes in the fair value of fair value hedges. In the six months ended June 30, 2001, the amount represents a \$3.2 million loss on the valuation of warrants, offset by a \$1.8 million gain representing the ineffective portions of changes in the fair value of fair value hedges.

Other non-operating income (expense) was \$0.3 million and \$(0.4) million in the three and six months ended June 30, 2001, respectively, and \$(1.0) million and \$(1.7) million in the three and six months ended June 30, 2000, respectively. Other non-operating expense, which is primarily comprised of foreign exchange gains (losses), was recorded primarily as a result of fluctuations in foreign exchange rates for assets and liabilities held on our balance sheet that are denominated in non-functional currencies.

Income Tax Expense (Benefit)

Income tax expense (benefit) represents the benefit for federal and state income taxes at an effective tax rate of (50)% and (57)% for the three and six months ended June 30, 2001, respectively, and 68% and (5)% for the three and six months ended June 30, 2000, respectively. The rate for the three and six months ended June 30, 2001 reflects an increase in the tax benefit due to federal and state research and development income tax credits, a decrease of the tax benefit for the amortization of goodwill and differences between our statutory and foreign effective tax rates. The rate for the three and six months ended June 30, 2000 reflects the tax impact of non-deductible acquisition-related expenses and amortization of goodwill arising from foreign acquisitions.

Minority Interest in Subsidiaries

Minority interest in subsidiaries was \$0.4 million and \$0.3 million in the three and six months ended June 30, 2001, respectively, and \$0.6 million and \$0.2 million in the three and six months ended June 30, 2000, respectively. Minority interest in subsidiaries results primarily from ETFC's interest payments to subsidiary trusts which have issued Company-obligated mandatorily redeemable capital securities and which hold junior subordinated debentures of the Company. Also included in minority interest in subsidiaries for the three months ended June 30, 2001 and 2000 is the net loss attributed to a minority interest in one of our international affiliates.

Extraordinary Gain on Early Extinguishment of Debt

The Company recorded an extraordinary gain on early extinguishment of debt of \$2.1 million (net of tax expense of \$1.8 million) and \$0.1 million (net of tax expense of \$600,000) in the three and six months ended June 30, 2001, respectively. In the three and six months ended June 30, 2001, amounts recorded included a \$5.0 million gain (net of tax expense of \$3.4 million) on exchanges in the aggregate of \$30.0 million of our 6% convertible subordinated notes for approximately 2.7 million shares of our common stock, offset by a \$2.9 million loss (net of tax benefit of \$1.6 million) and a \$4.9 million loss (net of tax benefit of \$2.8 million) in the three and six months ended June 30, 2001, respectively, recorded as a result of the early redemptions of \$100 million and \$600 million, respectively, of adjustable and fixed rate advances from the Federal Home Loan Bank of Atlanta, referred to in this Form 10-Q as the FHLB. The FHLB advances were entered into as a result of normal funding requirements of the Company's banking operations. The loss consisted primarily of prepayment penalties and costs associated with these early redemptions.

Liquidity and Capital Resources

We have financing facilities totaling \$346.9 million to meet the needs of E*TRADE Securities. These facilities, if used, would be collateralized by customer securities or restricted cash included in other assets. There was \$71.9 million in borrowings outstanding under these lines as of June 30, 2001, collateralized by restricted cash included in other assets. In addition, we have a short-term line of credit for up to \$50.0 million, collateralized by marketable securities owned by us, of which there were no outstanding borrowings as of June 30, 2001. We also have three term loans collateralized by equipment owned by us, of which \$16.9 million was outstanding as of June 30, 2001. We have also entered into numerous agreements with other broker-dealers to provide financing under our stock loan program.

On May 29, 2001, the Company completed a private offering of \$325 million convertible subordinated notes due May 2008. The notes are convertible, at the option of the holder, into a total of approximately 29.7 million shares of the Company's common stock at a conversion price of \$10.925 per share. The notes bear interest at 6.75%, payable semiannually, and are non-callable for three years and may then be called by the Company at a premium, which declines over time. The holders have the right to require redemption at a premium in the event of a change in control or other defined redemption event. The Company expects to use the net proceeds for general corporate purposes, including capital expenditures and to meet working capital needs. Debt issuance costs of \$10.5 million are included in other assets and are being amortized to interest expense over the term of the notes. Had these securities been issued at the beginning of the fiscal year, net loss per share would have increased to \$0.04 and \$0.08 for the three and six months ended June 30, 2001, respectively, as compared to net loss per share of \$0.03 and \$0.06 for the three and six months ended June 30, 2001, due to the additional net interest expense and issuance costs associated with the securities.

We currently anticipate that our available cash resources, credit facilities, and liquid portfolio of equity securities will be sufficient to meet our presently anticipated working capital and capital expenditure requirements for at least the next 12 months. However, as a result of the substantial market decline of technology stocks since December 31, 2000, the value of our equity investments in technology companies, recorded in our investment portfolio, has

deteriorated. As a result of significant market volatility during the three months ended June 30, 2001, we recognized a \$10.6 million impairment loss related to these equity investments and our proprietary mutual funds; these write-downs affect our liquidity. Additional write-downs and depreciation in the market value of our portfolio impacts our financing strategies and could result in higher interest expense if alternative financing strategies are used. We may need to raise additional funds in order to support more rapid expansion, develop new or enhanced services and products, respond to competitive pressures, acquire complementary businesses or technologies or take advantage of unanticipated opportunities. Our future liquidity and capital requirements will depend upon numerous factors, including costs and timing of expansion of technology development efforts and the success of such efforts, the success of our existing and new service offerings and competing technological and market developments. Our forecast of the period of time through which our financial resources will be adequate to support our operations is a forward-looking statement that involves risks and uncertainties, and actual results could vary. If additional funds are raised through the issuance of equity securities, the percentage ownership of the shareowners in our company will be reduced, shareowners may experience additional dilution in net book value per share or such equity securities may have rights, preferences or privileges senior to those of the holders of our common stock. There can be no assurance that additional financing will be available when needed on terms favorable to our Company, if at all. See "Item 2. Risk Factors—We may need additional funds in the future which may not be available and which may result in dilution of the value of our common stock."

If adequate funds are not available on acceptable terms, we may be unable to develop or enhance our services and products, take advantage of future opportunities or respond to competitive pressures, any of which could harm our business. See "Item 2. Risk factors—If we are unable to quickly introduce new products and services that satisfy changing customer needs, we could lose customers and have difficulty attracting new customers."

Cash used in operating activities, net of effects of acquisitions, was \$71.1 million for the six months ended June 30, 2001. Cash used in operating activities resulted primarily from an excess of purchases of banking-related assets over the net sale/maturity of banking-related assets of \$429.7 million and an increase in other assets of \$86.3 million, partially offset by depreciation, amortization and discount accretion of \$75.1 million, an increase in brokerage-related liabilities in excess of assets, net of effects of acquisitions, of \$274.2 million and an increase in accounts payable, accrued and other liabilities of \$137.1 million. Cash used in operating activities, net of effects of acquisitions and net of the effects of realized gains on the sale of available-for-sale securities, was \$286.5 million for the six months ended June 30, 2000. Cash used in operating activities resulted primarily from an increase in brokerage-related assets in excess of liabilities, net of effects of acquisitions, of \$400.6 million, an increase in other assets of \$108.4 million, offset by depreciation, amortization and discount accretion of \$59.5 million and an increase in accounts payable, accrued and other liabilities of \$169.3 million.

Cash used in investing activities was \$1,378.8 million and \$2,778.8 million for the six months ended June 30, 2001 and 2000, respectively. For the six months ended June 30, 2001 and 2000, cash used in investing activities resulted primarily from an increase in loans receivable and purchases of property and equipment, partially offset by an excess of the net sale/maturity of investments over the purchases of investments.

Cash provided by financing activities was \$1,431.2 million and \$2,946.5 million for the six months ended June 30, 2001 and 2000, respectively. For the six months ended June 30, 2001 and 2000, cash provided by financing activities primarily resulted from an increase in banking deposits and net advances from the FHLB, offset by payments on advances from the FHLB and an increase in proceeds from the issuance of subordinated debt.

Recent Developments

Power Crisis in California

We have undertaken the following measures to protect our business and operations from rolling power blackouts in California and elsewhere and also from other natural disasters:

- We maintain duplicative trading centers in Rancho Cordova, California and Alpharetta, Georgia, which are operated on a 24 x 7 x 365 day a year basis. Ordinarily both trading centers are in operation, handle live trading traffic and keep duplicate records for all trades. In the event of a power shortage or other natural disaster, we are able to divert all trading traffic to either our Rancho Cordova or Alpharetta facilities within a matter of minutes.
- We maintain back-up generators to support all critical buildings that directly support our trading operations and our customer service areas in both our Rancho Cordova and Alpharetta locations. Supplementing these generators, we maintain battery sources that can power our trading operations for up to thirty minutes to permit our back-up generators to start, and, if our back-up generators fail, to allow us sufficient time to divert trading traffic to the duplicate live trading center.
- We also maintain disaster recovery policies and have implemented weekly checks of our Rancho Cordova power generators. To date, our power generators have never failed to respond.

We do not feel that the possibility of power blackouts in California and elsewhere is a material risk to our business because of the redundant processes and back-up systems described above.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard, commonly referred to as SFAS, No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and other intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the new rules. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method of accounting and addresses the initial recognition and measurement of goodwill and intangible assets acquired in the business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. We will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of 2002. Upon adoption of SFAS No. 142, we will stop the amortization of goodwill with an estimated net carrying value of approximately \$416.6 million at December 31, 2001 and annual amortization expense of \$26.2 million that resulted from business combinations initiated prior to the adoption of SFAS No. 141. We will evaluate goodwill under the SFAS No. 142 transitional impairment test, and we have not yet determined whether or not there is an impairment loss. Any transitional impairment loss will be recognized as a change in accounting principle.

RISK FACTORS

RISKS RELATING TO THE NATURE OF THE ONLINE FINANCIAL SERVICES BUSINESS

We face competition from competitors, some of whom have significantly greater financial, technical, marketing and other resources, which could cause us to lower our prices or to lose a significant portion of our market share

The market for financial services over the Internet is new, rapidly evolving and intensely competitive. We expect competition to continue and intensify in the future. We face direct competition from financial institutions, brokerage firms, banks, mutual fund companies, Internet portals and other organizations, including among others:

- American Express Company
- AOL Time Warner Inc.
- Ameritrade, Inc.
- Bank of America Corporation
- Charles Schwab & Co., Inc.
- CSFBdirect (formerly DLJ direct)
- J.P. Morgan Chase & Co.
- Citigroup Inc.
- Datek Online Financial Services LLC (a subsidiary of Datek Online Holdings Corporation)
- Fidelity Investments
- FleetBoston Financial Corporation
- Intuit Inc.
- Merrill Lynch, Pierce, Fenner & Smith Incorporated
- CNBC MoneyCentral
- Morgan Stanley Dean Witter & Co.
- National Discount Brokers Corporation (which is currently owned by Deutsche Bank; plans to acquire NDB have been announced by Ameritrade, Inc.)
- NetBank, Inc.
- PaineWebber Group, Inc. (which is owned by UBS AG)
- Salomon Smith Barney, Inc. (which is owned by Citigroup)
- TD Waterhouse Group, Inc.
- Wells Fargo & Company
- bankone.com (a division of Bank One Corp.)
- Yahoo! Inc.

Many of our competitors have longer operating histories and significantly greater financial, technical, marketing and other resources than we do. In addition, many of our competitors offer a wider range of investment banking, advisory and other financial services and products than we do, and thus may be able to respond more quickly to new or changing opportunities, technologies and customer preferences and requirements. Many of our competitors also have greater name recognition and larger customer bases that could be leveraged, thereby gaining market share from us. These competitors may conduct more extensive promotional activities and offer better terms and lower prices to customers than we do, possibly even sparking a price war in the online financial services industry. Moreover, some of our competitors have established cooperative relationships among themselves or with third parties to enhance their services and products. It is possible that new competitors or alliances among existing competitors may significantly reduce our market share.

General financial success within the financial services industry over the past several years has strengthened existing competitors and may continue to attract new competitors, such as software development companies, insurance companies and others, as such companies expand their financial product lines. Commercial banks and other financial institutions have become more competitive with our brokerage operations by offering their customers certain corporate and individual financial services traditionally provided by securities firms. The current trend toward consolidation in the commercial banking industry could further increase competition in all aspects of our business. While we cannot predict the type and extent of competitive services that commercial banks and other financial institutions ultimately may offer, we may be harmed by such competition. To the extent our competitors are able to attract and retain customers, our business or ability to grow could be harmed.

There can be no assurance that we will be able to compete effectively with current or future competitors or that this competition will not significantly harm our business.

The security of our computers could be breached or confidential customer information transmitted over public networks could be breached or misused, which could deter customers from using our services and significantly damage our reputation

Because we rely heavily on electronic communications and secure transaction processing in our securities, banking and ATM businesses, we must protect our computer systems and network from physical break-ins, security breaches and other disruptions caused by unauthorized access. We must also provide for the secure transmission of confidential information over public networks and prevent unauthorized use of confidential customer information. The open nature of the Internet makes protecting against these threats more difficult. Unauthorized access to our computers could jeopardize the security of information stored in and transmitted through our computer systems and network, which could harm our ability to retain or attract customers, damage our reputation and subject us to litigation and financial losses. We have in the past, and could in the future, be subject to denial of service, vandalism and other attacks on our systems. We rely on encryption and authentication technology, including cryptography technology licensed from RSA Data Security, Inc., to provide secure transmission of confidential information over public networks. Advances in computer and decryption capabilities or other developments could compromise the methods we use to protect customer transaction data, which could harm our ability to retain or attract customers. In addition, we must guard against damage, fraud, embezzlement and unauthorized trading by persons with authorized access to our computer systems, including individuals employed by the Company. The security and encryption technology and the operational procedures we implement to prevent break-ins, damage and failures may be unable to prevent future disruptions of our operations. Our insurance coverage may be insufficient to cover losses that may result from these events.

As a significant portion of our revenues come from online investing services, downturns in the securities industry have harmed and could further significantly harm our business, including by reducing transaction volumes and margin borrowing and increasing our dependence on our more active customers who receive lower prices

A significant portion of our revenues in recent years has been from online investing services, and although we continue to diversify our revenue sources, we expect this business to continue to account for a significant portion of our revenues in the foreseeable future. We, like other financial services firms, are directly affected by economic and political conditions, broad trends in business and finance and changes in volume and price levels of securities and futures transactions. The U.S. securities markets are characterized by considerable fluctuation and downturns in these markets have harmed our operating results, including our transaction volume and the rate of growth of new accounts, and could continue to do so in the future. Significant downturns in the U.S. securities markets occurred in October 1987 and October 1989, and a significant downturn has been occurring since March 2000. Consequently, transaction volume has decreased industry-wide including a substantial decrease in the past quarter, and many broker-dealers, including E*TRADE Securities, have been adversely affected. The decrease in transaction volume has been more significant with respect to our less active customers, increasing our dependence on our more active Power E*TRADE customers who receive more favorable pricing based on their transaction volume. When transaction volume is low, our operating results are harmed in part because some of our overhead costs remain relatively fixed. We cannot assure you that U.S. securities markets will not continue to be volatile or that prices and transaction volumes will not continue to move downward, either of which could harm our business going forward. Some of our competitors with more diverse product and service offerings might withstand such a downturn in the securities industry better than we would. See “Item 2. Risk Factors—We face competition from competitors, some of whom have significantly greater financial, technical, marketing and other resources, which could cause us to lower our prices or to lose a significant portion of our market share.”

Downturns in the securities markets increase the risk that parties to margin lending transactions with us will fail to honor their commitments and that the value of the collateral we hold in connection with those transactions will not be adequate, increasing our risk of losses from our margin lending activities

We sometimes allow customers to purchase securities on margin, and we are therefore subject to risks inherent in extending credit. This risk is especially great when the market is rapidly declining and the value of the collateral we hold could fall below the amount of a customer's indebtedness. Under specific regulatory guidelines, any time we borrow or lend securities, we must correspondingly disburse or receive cash deposits. If we fail to maintain adequate cash deposit levels at all times, we run the risk of loss if there are sharp changes in market values of many securities and parties to the borrowing and lending transactions fail to honor their commitments. Any such losses could harm our financial position and results of operations.

Our inability to retain and hire skilled personnel and senior management could seriously harm our ability to maintain and grow our business

Over the past year, we hired a significant number of additional skilled personnel, including persons with experience in the computer, brokerage and banking industries, and persons with Series 7 or other broker-dealer licenses. If the number of accounts and transaction volume increases significantly over current volume, there could be a shortage of qualified and, in some cases, licensed personnel that we may then be seeking to hire which could cause a backlog in the handling of banking transactions or the processing of brokerage orders that need review, and that could harm our business, financial condition and operating results. Competition for such personnel is intense when trading volumes are high, and there can be no assurance that we will be able to retain or hire technical persons or licensed representatives in the future.

In addition, our future success depends to a significant degree on the skills, experience and efforts of our Chairman and Chief Executive Officer, President and Chief Operating Officer, Chief Financial Officer, Managing Directors and other key management personnel. The loss of the services of any of these individuals could compromise our ability to effectively operate our business.

If our ability to correctly process customer transactions is slowed or interrupted, we could be subject to customer litigation and our reputation could be harmed

We process customer transactions mostly through the Internet, online service providers, touch-tone telephones and our computer systems, and we depend heavily on the integrity of the communications and computer systems supporting these transactions, including our internal software programs and computer systems. A degradation or interruption in the operation of these systems could subject us to significant customer litigation and could materially harm our reputation. Our systems or any other systems in the transaction process could slow down significantly or fail for a variety of reasons including:

- undetected errors in software programs or computer systems,
- our inability to effectively resolve any errors in our internal software programs or computer systems once they are detected, or
- heavy stress placed on systems in the transaction process during certain peak trading times.

If our systems or any other systems in the transaction process slow down or fail even for a short time, our customers could suffer delays in transaction processing, which could cause substantial customer losses and may subject us to claims for these losses or to litigation. The NASDR defines a “system failure” as a shutdown of our mission critical systems (defined as those necessary for the acceptance and execution of online securities orders) which causes the customers’ use of these systems to equal or exceed system capacity during regular market hours, or a shutdown of any system application necessary for the

acceptance and execution of online securities orders for a period of 15 continuous minutes that affects 25% or more of the customers on the system from effecting securities transactions during regular market hours. We have experienced systems failures and degradation in the past. Systems failures and degradations could occur with respect to U.S. markets or foreign markets where we must implement new transaction processing infrastructures. To date, during our systems failures, we were able to take orders by telephone; however, with respect to our brokerage transactions, only associates with securities brokers' licenses can accept telephone orders. An adequate number of such associates may not be available to take customer calls in the event of a future systems failure, and we may not be able to increase our customer service personnel and capabilities in a timely and cost-effective manner. To promote customer satisfaction and protect our brand name, we have, on certain occasions, compensated customers for verifiable losses from such failures.

Increases in prevailing and anticipated interest rates would reduce the value of the Bank's fixed rate investments and may decrease the Bank's profitability by increasing the expense of variable rate interest-bearing liabilities without a corresponding increase in income from assets bearing a fixed rate of interest

The results of operations for the Bank depend in large part upon the level of its net interest income, that is, the difference between interest income from interest-earning assets, such as loans and mortgage-backed securities, and interest expense on interest-bearing liabilities, such as deposits and borrowings. Changes in market interest rates (and the yield curve) could reduce the value of the Bank's financial assets and thereby reduce net interest income. Fixed-rate investments, mortgage-backed and related securities and mortgage loans generally decline in value as interest rates rise. Many factors cause changes in interest rates, including governmental monetary policies and domestic and international economic and political conditions.

The Bank attempts to mitigate this interest rate risk by using derivative contracts that are designed to offset, in whole or in part, the variability in value or cash flow of various assets or liabilities caused by changes in interest rates. There can be no assurances that these derivative contracts move either directionally or proportionately as intended. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which the Company adopted on October 1, 2000, requires that the hedge ineffectiveness, or the change in value of the hedged item versus the change in value of the hedging instruments, be recognized in earnings as of the reporting date. Our financial results may prove to be more volatile due to this new reporting requirement.

If we are unsuccessful in managing the effects of changes in interest rates, our financial condition and results of operations could suffer.

The Bank's diversification of its asset portfolio to include higher yielding investments which carry a higher inherent risk of default in its portfolio may increase the risk of charge-offs which could reduce our profitability

As the Bank diversifies its asset portfolio through purchases of new higher yielding asset classes, we will have to manage assets that carry a higher inherent risk of default than experienced with our existing portfolio. Consequently, the level of charge-offs associated with these assets may be higher than previously experienced. If expectations of future charge-offs increase, a simultaneous increase in the amount of our loss reserves would be required. The increased level of charge-offs recorded to meet additional reserve requirements could harm the results of our operations if those higher yields do not cover the charge-offs.

We rely on a number of third parties to process our transactions, and their inability to expand their technology to meet our needs, or our inability to expand our own technology in the event of a significant increase in demand, could impair our ability to acquire new customers and otherwise grow our business

We rely on a number of third parties to process our transactions, including online and Internet service providers, back office processing organizations, other service providers and market-makers, all of which may need to expand the scope of the operations they perform for us. Any backlog caused by a third party's inability to expand sufficiently to meet our needs could harm our business. In addition, rapid growth in the use of our services could strain our own ability to adequately expand technologically to meet increased demand.

If we are unable to quickly introduce new products and services that satisfy changing customer needs, we could lose customers and have difficulty attracting new customers

Our future profitability depends significantly on our ability to develop and enhance our services and products. There are significant challenges to such development and enhancement, including technical risks. There can be no assurance that we will be successful in achieving any of the following:

- effectively using new technologies,
- adapting our services and products to meet emerging industry standards,
- developing, introducing and marketing service and product enhancements, or
- developing, introducing and marketing new services and products to meet customer demand.

Additionally, these new services and products, if they are developed, may not adequately meet the requirements of the marketplace or achieve market acceptance. If we are unable to develop and introduce enhanced or new services and products quickly enough to respond to market or customer requirements, or if they do not achieve market acceptance, our business could be harmed.

If our Business Solutions Group products fail or produce inaccurate results we could be subject to litigation and our reputation may be harmed

BSG provides products and services to assist companies to work effectively with their own legal, accounting and tax advisors to comply with the laws, regulations, and rules pertaining to equity compensation. BSG provides products and services that, by their nature, are highly technical and intricate, and that deal with issues which could result in significant accounting and tax reporting inaccuracies. If BSG's efforts to protect itself from liability arising from product design limitations and/or potential human error prove inadequate, these inaccuracies could subject us to customer litigation and damage our reputation.

The size of our market and our results of operations depend heavily upon the growing acceptance of the Internet as a commercial marketplace for

financial services

Because the electronic provision of financial services is currently the most significant part of our business, sales of most of our services and products will depend on consumers continuing to adopt the Internet as a method of doing business and, in particular, as a method of obtaining financial services. Several factors could adversely affect the acceptance and growth of online commerce. For example, there can be no assurance that the Internet infrastructure will continue to be able to support the demands placed on it by growing usage. In addition, the Internet could be adversely affected by the slow development or adoption of standards and protocols to handle increased Internet activity or by increased governmental regulation. Moreover, critical Internet issues including privacy, security, reliability, cost, ease of use, accessibility and quality of service remain unresolved, which could negatively affect the growth of Internet use or commerce on the Internet.

Even if Internet commerce grows generally, the online market for financial services could grow more slowly or even shrink in size. Adoption of online commerce for financial services by individuals who have relied upon traditional delivery channels in the past will require such individuals to accept new and different methods of conducting business. Consumers who trade with traditional brokerage firms, or even discount brokers, may be reluctant or slow to change to obtaining brokerage services over the Internet. Also, concerns about security and privacy on the Internet may hinder the growth of online investing and banking, which could harm our business.

If our international efforts are not successful, our business growth will be harmed and our resources will not have been used efficiently

One component of our strategy is a planned increase in efforts to attract more international customers. To date, we have limited experience in providing brokerage services internationally, and ETFC has had only limited experience providing banking services to customers outside the United States. There can be no assurance that we and/or our international licensees will be able to market our branded services and products successfully in international markets.

In order to expand our services globally, we must comply with the regulatory controls of each specific country in which we conduct business. Our international expansion could be limited by the compliance requirements of other regulatory jurisdictions, including the EU's Privacy Directive regulating the use and transfer of customer data. We intend to rely primarily on local third parties and our subsidiaries for regulatory compliance in foreign jurisdictions.

In addition, there are certain risks inherent in doing business in international markets, particularly in the heavily regulated brokerage and banking industries, such as:

- unexpected changes in regulatory requirements and trade barriers,
- difficulties in staffing and managing foreign operations,
- the level of investor interest in cross-border trading,
- authentication of online customers,
- political instability,
- fluctuations in currency exchange rates,
- reduced protection for intellectual property rights in some countries,
- possible fraud, embezzlement or unauthorized trading by our associates,
- seasonal reductions in business activity during the summer months in Europe and certain other parts of the world,
- the level of adoption of the Internet in international markets, and
- potentially adverse tax consequences.

Any of the foregoing could harm our international operations. In addition, because some of these international markets are served through license arrangements with others, we rely upon these third parties for a variety of business and regulatory compliance matters. We have limited control over the management and direction of these third parties. We run the risk that their action or inaction could harm our operations and/or our reputation. Additionally, certain of our international licensees have the right to grant sublicenses. Generally, we have less control over sublicensees than we do over licensees. As a result, the risk to our operations and goodwill is higher.

Our failure to successfully integrate the companies that we acquire into our existing operations could harm our business

We recently acquired ETFC, TIR, E*TRADE Access, Electronic Investing Corporation, PrivateAccounts Inc., renamed E*TRADE Advisory Services, Inc. on January 2, 2001, E*TRADE Technologies, LoansDirect, Inc. (which merged into and changed its name to E*TRADE Mortgage Corporation on June 15, 2001), WebStreet, Inc. and several of our international affiliates. We may also acquire other companies or technologies in the future, and we regularly evaluate such opportunities. Acquisitions entail numerous risks, including, but not limited to:

- difficulties in the assimilation and integration of acquired operations and products,
- diversion of management's attention from other business concerns,
- failure to achieve anticipated cost savings,
- failure to retain existing customers of the acquired companies,
- amortization of acquired intangible assets, with the effect of reducing our reported earnings, and
- potential loss of key associates of acquired companies.

No assurance can be given as to our ability to integrate successfully any operations, technology, personnel, services or new businesses or products that might be acquired in the future. Failure to successfully assimilate acquired organizations could harm our business. In addition, there can be no assurance that we will realize a positive return on any of these investments.

We have substantially increased our indebtedness, which may make it more difficult to make payments on our debts or to obtain financing

As a result of our sale in May 2001 of 6.75% convertible subordinated notes, we have incurred \$325 million of additional indebtedness, increasing our ratio of debt to equity (expressed as a percentage) from approximately 37% to approximately 55% as of June 30, 2001. We may incur additional indebtedness in the future. The level of our indebtedness, among other things, could

- make it more difficult to make payments on our debt,
- make it more difficult or costly for us to obtain any necessary financing in the future for working capital, capital expenditures, debt service requirements or other purposes,
- limit our flexibility in planning for or reacting to changes in our business, and
- make us more vulnerable in the event of a downturn in our business.

Any failure to maintain our relationships with strategic partners or loss in value of the investments we make could harm our business

We have established a number of strategic relationships and alliances with online and Internet service providers, investment banking and financial service providers, market makers and other vendors. There can be no assurance that each of these relationships or alliances will be maintained or that, if a relationship is maintained, it will be successful or profitable. There can be no assurance that the terms of any relationship or alliance with another party will be honored by that party. Additionally, we may not be able to develop new relationships or alliances of this type in the future.

We also make investments, either directly or through affiliated private investment funds, in equity securities of other companies without acquiring control of those companies. There may be no public market for the securities of the companies in which we invest, and we may not be able to sell these securities at a profit, or at all. We have in the past been required to write down the value of our investments in equity securities of other companies.

If we fail to protect our intellectual property rights or face a claim of intellectual property infringement by a third party, we could lose our intellectual property rights, be liable for significant damages, or incur significant costs and expenses regardless of the merits of the claims against us

Our ability to compete effectively is dependent to a significant degree on our brand and proprietary technology. We rely primarily on copyright, trade secret and trademark law to protect our technology and our brand. Effective trademark protection may not be available for our trademarks. Although we have registered the trademark “E*TRADE” in the United States and a number of other countries, and have other registered trademarks, there can be no assurance that we will be able to secure significant protection for these trademarks. Our competitors or others may adopt product or service names similar to “E*TRADE,” thereby impeding our ability to build brand identity and possibly leading to customer confusion. Our inability to adequately protect the name “E*TRADE” or our other trademarks could harm our business. Despite any precautions we take, a third party may be able to copy or otherwise obtain and use our software or other proprietary information without authorization or to develop similar software independently. Policing unauthorized use of our technology is made especially difficult by the global nature of the Internet and difficulty in controlling the ultimate destination or security of software or other data transmitted on it. The laws of other countries may afford us little or no effective protection for our intellectual property. There can be no assurance that the steps we take will prevent misappropriation of our technology or that agreements entered into for that purpose will be enforceable. In addition, litigation may be necessary in the future to:

- enforce our intellectual property rights,
- protect our trade secrets,
- determine the validity and scope of the proprietary rights of others, or
- defend against claims of infringement or invalidity.

Such litigation, whether successful or unsuccessful, could result in substantial costs and divert resources, either of which could harm our business.

We have received in the past, and may receive in the future, notices of claims of infringement of other parties’ proprietary rights. There can be no assurance that claims for infringement or invalidity—or any indemnification claims based on such claims—will not be asserted or prosecuted against us. Any such claims, with or without merit, could be time consuming and costly to defend or litigate, divert our attention and resources or require us to enter into royalty or licensing agreements. There can be no assurance that such licenses would be available on reasonable terms, if at all.

The Company’s efforts to expand its recognition of the E*TRADE brand to areas of the financial services industry other than online trading may not be effective

As the Company diversifies the scope of the products and services it offers, the brand “E*TRADE” may not be as effective for us in the future, which could negatively impact our revenues. In addition, the Company’s efforts to further its brand as a diversified financial services institution is largely dependent on our use of effective marketing and advertising efforts. If these efforts are not successful, we will not have used resources effectively.

Provisions in our certificate of incorporation and bylaws, our stockholder rights plan and Delaware law could prevent or delay an acquisition of us that a shareowner may consider to be favorable

Certain provisions of our certificate of incorporation and bylaws may discourage, delay or prevent a third party from acquiring control of us in a merger,

acquisition or similar transaction that a shareowner may consider favorable. Such provisions include:

- authorization for the issuance of “blank check” preferred stock,
- provision for a classified board of directors with staggered, three-year terms,
- the prohibition of cumulative voting in the election of directors,
- a super-majority voting requirement to effect business combinations or certain amendments to our certificate of incorporation and bylaws,
- limits on the persons who may call special meetings of shareowners,
- the prohibition of shareowner action by written consent, and
- advance notice requirements for nominations to the board of directors or for proposing matters that can be acted on by shareowners at shareowner meetings.

Attempts to acquire control of us may also be delayed or prevented by our stockholder rights plan. The stockholder rights plan is designed to enhance the ability of our Board of Directors to protect shareowners against, among other things, unsolicited attempts to acquire control of us that do not offer an adequate price to all shareowners or are otherwise not in the best interests of us and our shareowners. In addition, certain provisions of our stock incentive plans and Delaware law may also discourage, delay or prevent someone from acquiring or merging with us.

RISKS RELATING TO THE REGULATION OF OUR BUSINESS

If changes in government regulation, including banking and securities rules and regulations, favor our competition or restrict our business practices, our ability to attract and retain customers and our profitability may suffer

The securities industry in the United States is subject to extensive regulation under both federal and state laws. The banking industry in the United States is subject to extensive federal regulation. Broker-dealers are subject to regulations covering all aspects of the securities business, which include:

- sales methods,
- recommendations of securities,
- trading practices among broker-dealers,
- execution of customers’ orders,
- use and safekeeping of customers’ funds and securities,
- capital structure,
- record keeping,
- advertising,
- conduct of directors, officers and employees, and
- supervision.

Because we are a self-clearing broker-dealer, we have to comply with many additional laws and rules. These include rules relating to possession and control of customer funds and securities, margin lending and execution and settlement of transactions. Our ability to comply with these rules depends largely on the establishment and maintenance of a qualified compliance system.

Similarly, E*TRADE and ETFC, as savings and loan holding companies, and the Bank, as a federally chartered savings bank and subsidiary of ETFC, are subject to extensive regulation, supervision and examination by the OTS, and, in the case of the Bank, the FDIC. Such regulation covers all aspects of the banking business, including lending practices, safeguarding deposits, capital structure, record keeping, and conduct and qualifications of personnel.

Because of our international presence, we are also subject to the regulatory controls of each specific country in which we conduct business.

Because we operate in an industry subject to extensive regulation, the competitive landscape in our industry can change significantly as a result of new regulation, changes in existing regulation, or changes in the interpretation or enforcement of existing laws and rules. For example, in November 1999, the Gramm-Leach-Bliley Act was enacted into law. This act reduces the legal barriers between banking, securities and insurance companies, and will make it easier for financial holding companies to compete directly with our securities business, as well as for our competitors in the securities business to diversify their revenues and attract additional customers through entry into the banking and insurance businesses. The Gramm-Leach-Bliley Act may have a material impact on the competitive landscape that we face. Similarly, in February 2001, the Securities Exchange Commission approved amendments to NASD Rule 2520 governing margin requirements for “pattern day traders” which amendments will become effective September 28, 2001. Among other requirements, these amendments will require “pattern day traders” to have deposited in their accounts a minimum equity of \$25,000 on any day in which the customer day trades. The amendments to NASD Rule 2520 could affect the behavior of certain of our most active customers and negatively impact our revenues.

There can be no assurance that federal, state or foreign agencies will not further regulate our business. We anticipate that we may be required to comply with record keeping, data processing and other regulatory requirements as a result of proposed federal legislation or otherwise. We may also be subject to additional regulation as the market for online commerce evolves. Because of the growth in the electronic commerce market, Congress has held hearings on whether to regulate providers of services and transactions in the electronic commerce market. As a result, federal or state authorities could enact laws, rules or regulations affecting our business or operations. We may also be subject to federal, state or foreign money transmitter laws and state and foreign sales or use tax laws. If such laws are enacted or deemed applicable to us, our business or operations could be rendered more costly or burdensome, less efficient or even

impossible. Any of the foregoing could harm our business, financial condition and operating results.

If we fail to comply with applicable securities and banking regulations, we could be subject to disciplinary actions, damages, penalties or restrictions that could significantly harm our business

The SEC, the NASDR or other self-regulatory organizations and state securities commissions can censure, fine, issue cease-and-desist orders or suspend or expel a broker-dealer or any of its officers or employees. The OTS may take similar action with respect to our banking activities. Our ability to comply with all applicable laws and rules is largely dependent on our establishment and maintenance of a system to ensure such compliance, as well as our ability to attract and retain qualified compliance personnel. We could be subject to disciplinary or other actions due to claimed noncompliance in the future, which could harm our business.

If we do not maintain the capital levels required by regulators, we may be fined or forced out of business

The SEC, NASDR, OTS and various other regulatory agencies have stringent rules with respect to the maintenance of specific levels of net capital by securities broker-dealers and regulatory capital by banks. Net capital is the net worth of a broker or dealer (assets minus liabilities), less deductions for certain types of assets. If a securities firm fails to maintain the required net capital it may be subject to suspension or revocation of registration by the SEC and suspension or expulsion by the NASDR, and could ultimately lead to the firm's liquidation. In the past, our broker-dealer subsidiaries have depended largely on capital contributions by us in order to comply with net capital requirements. If such net capital rules are changed or expanded, or if there is an unusually large charge against net capital, operations that require the intensive use of capital could be limited. Such operations may include investing activities, marketing and the financing of customer account balances. Also, our ability to withdraw capital from brokerage subsidiaries could be restricted, which in turn could limit our ability to pay dividends, repay debt and redeem or purchase shares of our outstanding stock. A large operating loss or charge against net capital could adversely affect our ability to expand or even maintain our present levels of business, which could harm our business.

The table below summarizes the minimum net capital requirements for our domestic broker-dealer subsidiaries as of June 30, 2001 (in thousands):

	Required Net Capital	Net Capital	Excess Net Capital
E*TRADE Securities Incorporated	\$43,691	\$347,662	\$303,971
E*TRADE Institutional Securities, Inc.	\$ 250	\$ 1,424	\$ 1,174
E*TRADE Investor Select, Inc.	\$ 5	\$ 232	\$ 227
Marquette Securities, Inc.	\$ 250	\$ 515	\$ 265
E*TRADE Global Asset Management, Inc.	\$ 228	\$ 13,152	\$ 12,924
E*TRADE Canada Securities Corporation	\$ 100	\$ 286	\$ 186
Web Street Securities, Inc.	\$ 925	\$ 2,339	\$ 1,414

Similarly, banks, such as the Bank, are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could harm a bank's operations and financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, a bank must meet specific capital guidelines that involve quantitative measures of a bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. A bank's capital amounts and classification are also subject to qualitative judgments by the regulators about the strength of components of the bank's capital, risk weightings of assets and off-balance-sheet transactions, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require a bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. To be categorized as well capitalized, a bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table.

The table below summarizes the capital adequacy requirements for the Bank as of June 30, 2001 (dollars in thousands):

	Actual		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio
Core Capital (to adjusted tangible assets)	\$742,452	5.8%	\$637,827	5.0%
Tier 1 Capital (to risk weighted assets)	\$742,452	11.4%	\$390,402	6.0%
Total Capital (to risk weighted assets)	\$757,426	11.6%	\$650,670	10.0%

Restrictions on the ability of, or decreased willingness of, third parties to make payments for order flow or potential payments by us to third parties for handling orders could reduce our profitability

Order flow revenue is comprised of rebate income from various market makers and market centers for processing transactions through them. There can be no assurance that payments for order flow will continue to be permitted by the SEC, the NASDR or other regulatory agencies, courts or governmental units. In addition, the listed marketplaces other than Nasdaq moved from trading using fractional share prices to trading using decimals in January 2001 and the Nasdaq initiated decimalization in March 2001. With the advent of decimalization, certain market makers have reduced payments for order flow, others have announced plans to reduce payments for order flow, and others are taking a "wait and see" approach. It is possible that some market makers and market centers could begin charging companies that direct order flow to them. As a majority of our order flow revenues is derived from Nasdaq listed securities, we were negatively affected by decimalization during the quarter ended June 30, 2001. The impact of decimalization on future revenues cannot be accurately predicted at this time, and a continued, general decrease in these revenues is expected. Further, there can be no assurance that we will be able to continue our present relationships and terms for payments for order flow. Loss of any or all of these revenues could harm our business.

Regulatory review of our advertising practices could hinder our ability to operate our business and result in fines and other penalties

All marketing activities by E*TRADE Securities are regulated by the NASDR, and all marketing materials must be reviewed by an E*TRADE Securities Series 24 licensed principal prior to release. The NASDR has in the past asked us to revise certain marketing materials. In July 2001, we settled a formal NASDR investigation into our advertising practices and were fined by the NASDR in connection with three advertisements that were placed in 1999. The NASDR can impose certain penalties for violations of its advertising regulations, including:

- censures or fines,
- suspension of all advertising,
- the issuance of cease-and-desist orders, or
- the suspension or expulsion of a broker-dealer or any of its officers or employees.

In addition, the federal banking agencies impose restrictions on bank advertising of non-deposit investment products to minimize the likelihood of customer confusion.

If we were to solicit orders from our customers or make investment recommendations, we would become subject to additional regulations that could be burdensome and subject us to fines and other penalties

We do not currently solicit orders from our customers or make investment recommendations. However, if we were to engage in such activities, we would become subject to additional rules and regulations governing, among other things, sales practices and the suitability of recommendations to customers. Compliance with these regulations could be burdensome, and, if we fail to comply, we could be subject to fines and other penalties. We are continuing to develop technology, through a joint venture, that may enable us to provide financial advice for online investors in the future.

Due to the increasing popularity of the Internet, laws and regulations may be passed dealing with issues such as user privacy, pricing, content and quality of products and services, and those regulations could adversely affect the growth of the online financial services industry

As required by the Gramm-Leach-Bliley Act, the SEC and OTS have recently adopted regulations on financial privacy which took effect in July 2001 that require E*TRADE Securities and the Bank to notify consumers about the circumstances in which they may share consumers' personal information with unaffiliated third parties and to give consumers the right to prohibit such information sharing in specified circumstances. Although E*TRADE Securities and the Bank already provide such opt-out rights in our privacy policies, the regulations require us to modify the text and the form of presentation of our privacy policies and to incur additional expense to ensure ongoing compliance with the regulations.

In addition, several recent reports have focused attention on the online brokerage industry. For example, the New York Attorney General investigated the online brokerage industry and issued a report in November 1999, citing consumer complaints about delays and technical difficulties in companies conducting online stock trading. SEC Commissioner Laura Unger also issued a report in November 1999 on issues raised by online brokerage, including suitability and marketing issues. Most recently, the United States General Accounting Office issued a report citing a need for better investor protection information on brokers' Web sites and, on January 25, 2001, the SEC issued a report summarizing its findings and recommendations following an examination of broker-dealers offering online trading.

Increased attention focused upon these issues could hurt the growth of the online financial services industry, which could, in turn, decrease the demand for our services or otherwise harm our business.

Due to our acquisition of ETFC, we are subject to regulations that could restrict our ability to take advantage of good business opportunities and that may be burdensome to comply with

Upon the completion of our acquisition of ETFC and its subsidiary, the Bank, on January 12, 2000, we became subject to regulation as a savings and loan holding company. As a result, we, as well as the Bank, are required to file periodic reports with the OTS, and are subject to examination by the OTS. The OTS also has certain types of enforcement power over ETFC and us, including the ability to issue cease-and-desist orders, up to and including forcing divestiture of the Bank, and civil money penalties, for violating the Savings and Loan Holding Company Act. In addition, under the Graham-Leach-Bliley Act, our activities are now restricted to activities that are financial in nature and certain real estate-related activities. We may make merchant banking investments in companies whose activities are not financial in nature, if those investments are engaged in for the purpose of appreciation and ultimate resale of the investment and we do not manage or operate the company. Such merchant banking investments may be subject to maximum holding periods and special recordkeeping and risk management requirements.

We believe that all of our existing activities and investments are permissible under the new legislation, but the OTS has not interpreted these provisions. Even if all of our existing activities and investments are permissible, under the new legislation we will be constrained in pursuing future new activities that are not financial in nature. We are also limited in our ability to invest in other savings and loan holding companies. These restrictions could prevent us from pursuing certain activities and transactions that could be beneficial to us.

In addition to regulation of us and ETFC as savings and loan holding companies, federal savings banks such as the Bank are subject to extensive regulation of their activities and investments, their capitalization, their risk management policies and procedures, and their relationship with affiliated companies. In addition, as a condition to approving our acquisition of ETFC, the OTS imposed various notice and other requirements, primarily a requirement that the Bank obtain prior approval from the OTS of any future material changes to the Bank's business plan. These regulations and conditions, and our inexperience with them, could affect our ability to realize synergies from the acquisition, and could negatively affect both us and the Bank following the acquisition and could also delay or prevent the development, introduction and marketing of new products and services.

We may incur costs to avoid investment company status and our business would suffer significant harm if we were deemed to be an investment company

We may incur significant costs to avoid investment company status and may suffer other adverse consequences if we are deemed to be an investment company under the Investment Company Act of 1940, commonly referred to as the 1940 Act.

A company may be deemed to be an investment company if it owns investment securities with a value exceeding 40% of its total assets, subject to

certain exclusions. As a result of the sale in May 2001 of \$325 million principal amount of our convertible subordinated notes, we will have substantial short-term investments until the net proceeds from the sale can be deployed. In addition, we and our subsidiaries have made minority equity investments in other companies that may constitute investment securities under the 1940 Act. In particular, many of our publicly-traded equity investments, which are owned directly or indirectly by us or through related venture funds, are deemed to be investment securities. Although our investment securities currently comprise less than 40% of our total assets, the value of these minority investments has fluctuated in the past, and substantial appreciation in some of these investments or a decline in our total assets may, from time to time, cause the value of our investment securities to exceed 40% of our total assets. These factors may result in us being treated as an “investment company” under the 1940 Act.

We believe we are primarily engaged in a business other than investing, reinvesting, owning, holding, or trading securities for our account and, therefore, are not an investment company within the meaning of the 1940 Act. However, in the event that the 40% limit were to be exceeded (including through fluctuations in the value of our investment securities), we may need to reduce our investment securities as a percentage of our total assets. This reduction can be attempted in a number of ways, including the sale of investment securities and the acquisition of non-investment security assets, such as cash, cash equivalents and U.S. government securities. If we sell investment securities, we may sell them sooner than we intended. These sales may be at depressed prices and we may never realize anticipated benefits from, or may incur losses on, these investments. Some investments may not be sold due to normal contractual or legal restrictions or the inability to locate a suitable buyer. Moreover, we may incur tax liabilities if we sell these assets. We may also be unable to purchase additional investment securities that may be important to our operating strategy. If we decide to acquire non-investment security assets, we may not be able to identify and acquire suitable assets, and will likely realize a lower return on any such investments.

If we were deemed to be an investment company, we could become subject to substantial regulation under the 1940 Act with respect to our capital structure, management, operations, affiliate transactions and other matters. As a consequence, we could be barred from engaging in business or issuing our securities as we have in the past and might be subject to civil and criminal penalties for noncompliance. In addition, some of our contracts might be voidable, and a court-appointed receiver could take control of us and liquidate our business in certain circumstances.

RISKS RELATING TO OWNING OUR STOCK

Our historical quarterly results have fluctuated and do not reliably indicate future operating results

We do not believe that our historical operating results should be relied upon as an indication of our future operating results. We expect to experience large fluctuations in future quarterly operating results that may be caused by many factors, including the following:

- fluctuations in the fair market value of our equity investments in other companies, including through existing or future private investment funds managed by us,
- fluctuations in interest rates, which will impact our investment and loan portfolios,
- changes in trading volume in securities markets,
- the success of, or costs associated with, acquisitions, joint ventures or other strategic relationships,
- changes in key personnel,
- seasonal trends,
- purchases and sales of securities and other assets as part of the Bank’s portfolio restructuring efforts,
- customer acquisition costs, which may be affected by competitive conditions in the marketplace,
- the timing of introductions or enhancements to online financial services and products by us or our competitors,
- market acceptance of online financial services and products,
- domestic and international regulation of the brokerage, banking and Internet industries,
- accounting for derivative instruments and hedging activities,
- changes in domestic or international tax rates,
- changes in pricing policies by us or our competitors,
- fluctuation in foreign exchange rates, and
- changes in the level of operating expenses to support projected growth.

We have also experienced fluctuations in the average number of customer transactions per day. Thus, the rate of growth in customer transactions at any given time is not necessarily indicative of future transaction activity.

We have incurred losses in the past and we cannot assure you that we will be profitable

We have a long history of incurring operating losses in each fiscal year and we may incur operating losses in the future. We incurred net losses of \$402,000 in fiscal 1998 and \$56.8 million in fiscal 1999. Although we achieved profitability in fiscal 2000 due in part to sales of investment securities, we cannot assure you that profitability will be sustained.

The market price of our common stock may continue to be volatile which could cause litigation against us and the inability of shareowners to resell their shares at or above the prices at which they acquire them

From January 1, 2001 through June 30, 2001, the price per share of our common stock has ranged from a high of \$15.38 to a low of \$5.32. The market price of our common stock has been, and is likely to continue to be, highly volatile and subject to wide fluctuations due to various factors, many of which may be beyond our control, including:

- quarterly variations in operating results,
- volatility in the stock market,
- volatility in the general economy,
- changes in interest rates,
- announcements of acquisitions, technological innovations or new software, services or products by us or our competitors, and
- changes in financial estimates and recommendations by securities analysts.

In addition, there have been large fluctuations in the prices and trading volumes of securities of many technology, Internet and financial services companies. This volatility is often unrelated or disproportionate to the operating performance of these companies. Broad market and industry factors may decrease the market price of our common stock. In the past, volatility in the market price of a company's securities has often led to securities class action litigation. Such litigation could result in substantial costs to us and divert our attention and resources, which could harm our business. Declines in the market price of our common stock or failure of the market price to increase could also harm our ability to retain key associates, our access to capital and other aspects of our business, which also could harm our business.

We may need additional funds in the future which may not be available and which may result in dilution of the value of our common stock

In the future, we may need to raise additional funds for various purposes, including to expand our technology resources, to hire additional associates, to make acquisitions or to increase the Bank's total assets or deposit base. Additional financing may not be available on favorable terms, if at all. If adequate funds are not available on acceptable terms, we may be unable to fund our business growth plans. In addition, if funds are available, the result of our issuing securities could be to dilute the value of shares of our common stock and cause the market price to fall.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

For quantitative and qualitative disclosures about market risk, we have evaluated such risk for our domestic retail brokerage, banking, global and institutional, and asset gathering and other segments separately. The following discussion about our market risk disclosures includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including those set forth in the section entitled "Risk factors" and elsewhere in this filing.

Domestic Retail Brokerage, Global and Institutional, and Asset Gathering and Other

Our domestic retail brokerage, global and institutional, and asset gathering and other operations are exposed to market risk related to changes in interest rates, foreign currency exchange rates and equity security price risk. However, we do not believe any such exposures are material. To reduce certain risks, we utilize derivative financial instruments; however, we do not hold derivative financial instruments for speculative or trading purposes.

Interest Rate Sensitivity

During the quarter ended June 30, 2001, we had a variable rate bank line of credit and three variable rate term loans. As of June 30, 2001, we had no borrowings outstanding under this line of credit and \$16.9 million outstanding under these term loans. The line of credit and term loans and the monthly interest payments are subject to interest rate risk. If market interest rates were to increase immediately and uniformly by one percent at June 30, 2001, the interest payments would increase by an immaterial amount.

Foreign Currency Exchange Risk

A portion of our operations consist of brokerage and investment services outside of the United States. As a result, our results of operations could be adversely affected by factors such as changes in foreign currency exchange rates or economic conditions in the foreign markets in which we provide our services. We are primarily exposed to changes in exchange rates on the Japanese yen, the British pound, the Canadian dollar and the Euro. When the U.S. dollar strengthens against these currencies, the U.S. dollar value of non-U.S. dollar-based revenues decreases. When the U.S. dollar weakens against these currencies, the U.S. dollar value of non-U.S. dollar-based revenues increases. Correspondingly, the U.S. dollar value of non-U.S. dollar-based costs increases when the U.S. dollar weakens and decreases when the U.S. dollar strengthens. We are a net payer of British pounds and, as such, benefit from a stronger dollar, and are adversely affected by a weaker dollar relative to the British pound. However, we are a net receiver of currencies other than British pounds, and as such, benefit from a weaker dollar, and are harmed by a stronger dollar relative to these currencies. Accordingly, changes in exchange rates may adversely affect our consolidated sales and operating margins as expressed in U.S. dollars.

To mitigate the short-term effect of changes in currency exchange rates on our non-U.S. dollar-based revenues and operating expenses, we routinely hedge our material net non-U.S. dollar-based exposures by entering into foreign exchange forward and option contracts. Currently, hedges of transactions do not extend beyond twelve months and are immaterial. Given the short-term nature of our foreign exchange forward and option contracts, our exposure to risk associated with currency market movement on the instruments is not material.

Equity Price Risk

We have investments in publicly-traded equity securities which, in conjunction with cash provided from operations and financing arrangements, are utilized to meet forecasted liquidity needs. The fair value of these securities at June 30, 2001 was \$15.1 million. As a result of the sustained market value decline through the six months ended June 30, 2001, we recognized a \$10.6 million impairment loss related to these equity investments and our proprietary mutual funds; these write-downs affect our liquidity. Additional write-downs and depreciation in the market value of our portfolio impacts our financing

strategies and could result in higher interest expense if alternative financing strategies are used. At June 30, 2001, unrealized gains on these securities were \$920,000 and unrealized losses on these securities were none.

Financial Instruments

For our working capital and reserves, which are required to be segregated under Federal or other regulations, we primarily invest in money market funds, resale agreements, certificates of deposit, and commercial paper. Money market funds do not have maturity dates and do not present a material market risk. The other financial instruments are fixed rate investments with short maturities and do not present a material interest rate risk.

Banking Operations

We manage our banking related interest rate risk through the use of derivatives such as interest rate cap, swap and floor agreements. We use these instruments to ensure that the market value of equity and net interest income are protected from the impact of changes in interest rates. During the quarter, changes in interest rates, increasing prepayments, portfolio restructurings, and additional hedging activity substantially changed our market risk.

We employ various techniques to try to manage the variability of the fair value of equity by controlling the relative sensitivity of market value of interest-earning assets and interest-bearing liabilities. The sensitivity of changes in market value of assets and liabilities is affected by factors, including the level of interest rates, market expectations regarding future interest rates, projected related loan prepayments and the repricing characteristics of interest-bearing liabilities. We use hedging techniques to reduce the variability of fair value of equity and its overall interest rate risk exposure over a one- to seven-year period.

We also monitor our assets and liabilities by examining the extent to which those assets and liabilities are interest rate sensitive and by monitoring the interest rate sensitivity gap. An asset or liability is said to be interest rate sensitive within a specific period if it will mature or reprice within that period. The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets maturing or repricing within a specific time period and the amount of interest-bearing liabilities maturing or repricing within the same time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities and is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. Generally, during a period of rising interest rates, a negative gap would adversely affect net interest income, while a positive gap would result in an increase in net interest income.

The following assumptions were used to prepare our gap table at June 30, 2001. Non-amortizing investment securities are shown in the period in which they contractually mature. Investment securities that contain embedded options such as puts or calls are shown in the period in which that security is currently expected to be put or called or to mature. The table assumes that adjustable-rate residential mortgage loans and mortgage-backed securities prepay at an annual rate of between 10% and 40%, based on estimated future prepayment rates for comparable market benchmark securities and the Bank's prepayment history. The table also assumes that fixed-rate, residential loans and mortgage-backed securities prepay, at an annual rate of between 8% and 35%. The above assumptions were applied on a pool-by-pool basis depending on the pools characteristics which include, but are not limited to, the following: product type, coupon rate, rate adjustment frequency, periodic cap, lifetime cap and net coupon reset margin. Time deposits are shown in the period in which they contractually mature, and savings deposits are shown to reprice immediately. The interest rate sensitivity of our assets and liabilities could vary substantially if different assumptions were used or if actual experience differs from the assumptions used.

The following table sets forth our gap at June 30, 2001 (dollars in thousands):

	Balance at June 30, 2001	Percent of Total	Repricing Within 0-3 Months	Repricing Within 4-12 Months	Repricing Within 1-5 Years	Repricing in More Than 5 Years
Interest-earning banking assets:						
Loans receivable, net	\$ 6,911,940	56.36%	\$ 457,787	\$ 988,944	\$4,331,569	\$1,133,640
Mortgage-backed securities, available-for-sale and trading	4,000,796	32.63%	201,791	288,899	1,257,884	2,252,222
Investment securities, available-for-sale and FHLB stock	1,282,966	10.46%	197,486	112,844	650,259	322,377
Federal funds sold and interest bearing deposits	67,402	0.55%	67,402	—	—	—
Total interest-earning banking assets	12,263,104	100.00%	\$ 924,466	\$1,390,687	\$6,239,712	\$3,708,239
Non-interest-earning banking assets	422,569					
Total banking assets	\$ 12,685,673					
Interest-bearing banking liabilities:						
Savings deposits	\$ 1,893,735	16.44%	\$ —	\$ —	\$1,893,735	\$ —
Time deposits	5,793,271	50.29%	1,239,212	3,372,747	1,164,670	16,642
FHLB advances	873,300	7.58%	773,300	—	50,000	50,000
Other borrowings	2,959,587	25.69%	2,959,587	—	—	—
Total interest-bearing banking liabilities	11,519,893	100.00%	\$4,972,099	\$3,372,747	\$3,108,405	\$ 66,642
Non-interest-bearing banking liabilities	377,384					
Total banking liabilities	\$ 11,897,277					
Periodic gap			\$(4,047,633)	\$(1,982,060)	\$3,131,307	\$3,641,597
Cumulative gap			\$(4,047,633)	\$(6,029,693)	\$(2,898,386)	\$ 743,211
Cumulative gap to total assets			(31.9)%	(47.5)%	(22.8)%	5.9%
Cumulative gap to total assets hedge affected			8.2%	7.0%	(18.2)%	5.9%
As of September 30, 2000:						
Cumulative gap to total assets			(36.9)%	(49.1)%	(24.0)%	6.5%

Cumulative gap to total assets hedge
affected

1.1% (12.8%) (21.5%) 6.5%

As of June 30, 2001, the Bank's cumulative one-year gap and five-year gap to total assets hedge affected of 7% and negative 18.2% have decreased from negative 12.8% and negative 21.5% as of September 30, 2000. The changes are due largely to additional hedging activity and the shortening of duration of the mortgage assets as a result of lower interest rates and faster prepayment assumptions.

PART II. OTHER INFORMATION

Item 1. Legal and Administrative Proceedings

Reference is made to the information reported in prior filings with the Securities and Exchange Commission under Item 3. Legal and Administrative Proceedings in our Annual Report on Form 10-K, as amended, for the year ended September 30, 2000, and under Part II Item 1. Legal and Administrative Proceedings in our Transition Report on Form 10-QT for the quarter ended December 31, 2000 and our Report on Form 10-Q for the quarter ended March 31, 2001.

From time to time, we have been threatened with, or named as a defendant in, lawsuits, arbitrations and administrative claims involving both securities related and non-securities related matters. We are also subject to periodic regulatory audits and inspections. Compliance and trading problems that are reported to regulators such as the SEC or the NASDR by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal arbitration claims being filed against us by customers and/or disciplinary action being taken against us by regulators. Any such claims or disciplinary actions that are decided against us could harm our business. The securities industry is subject to extensive regulation under federal, state and applicable international laws. As a result, we are required to comply with many complex laws and rules and our ability to so comply is dependent in large part upon the establishment and maintenance of a qualified compliance system.

We maintain insurance in such amounts and with such coverages, deductibles and policy limits as management believes are reasonable and prudent. The principal risks that we insure against are comprehensive general liability, commercial property damage, hardware and software damage, directors and officers, fidelity (crime) bond, and errors and omissions liability. We believe that such insurance coverage is adequate for the purpose of our business.

Item 2. Changes in Securities and Use of Proceeds

On January 2, 2001, the Company's Board of Directors issued restricted stock grants of an aggregate total of 1,279,333 shares to the executive officers of the Company, which are scheduled to vest monthly over a four year period. On January 2, 2001, the Company's Board of Directors issued a restricted stock grant of 666,666 shares to the Chief Executive Officer of the Company, which is scheduled to vest monthly over an 18 month period. On April 6, 2001, the Company's Board of Directors issued a restricted stock grant of 4,000,000 shares to the Company's Chief Executive Officer, which is scheduled to vest monthly over a five year period. The Company has utilized its restricted stock as an incentive to attract and keep qualified experienced key personnel. Under the terms of all of these restricted stock grants, the Company has a right to repurchase any unvested shares at the original exercise price of the shares upon termination of employment. All of the issuances of restricted stock by the Company have been transactions "not involving a public offering" and therefore were exempted transactions under Section 4(2) of the Securities Act.

On March 12, 2001, the Company authorized the issuance of an aggregate of 618,057 shares of unregistered common stock in connection with the acquisition of PrivateAccounts, Inc. (renamed E*TRADE Advisory Services Inc. on January 2, 2001). The shares were deposited into escrow pursuant to the terms of the merger agreement as a portion of the consideration for the merger. No underwriters were involved, and there were no underwriting discounts or commissions. The securities were issued in reliance upon the exemption from registration provided under Section 4(2) of the Securities Act based on the fact that the common stock was sold by the issuer in a transaction not involving a public offering. On March 20, 2001, the Bank of New York as escrow agent authorized the release from escrow of 478,500 of the shares of common stock. On June 22, 2001, the Company filed a registration statement with the Securities and Exchange Commission for the resale of these 478,500 shares. The registration statement has not yet been declared effective. In addition, the above-referenced registration statement included the registration of 134,820 shares issued upon the exercise of certain warrants assumed in connection with the acquisition of E*TRADE Financial Corporation. No underwriters were involved, and there were no underwriting discounts or commissions. The warrants were originally issued in reliance upon the exemption from registration provided under Section 4(2) of the Securities Act based on the fact that warrants were sold by the original issuer in a sale not involving a public offering.

In May 2001, the Company consummated the sale of its 6³/₄% percent convertible subordinated notes due 2008, referred to herein as the Notes, in the aggregate principal amount of \$325 million. J.P. Morgan Securities Inc. was the initial purchaser. The Notes are convertible, in whole or in part, at any time prior to maturity, at the option of the holders, unless previously redeemed or repurchased, into shares of the Company's common stock at a conversion price of \$10.925 per share, a 25% premium to the closing price of the common stock on the date of pricing. The Notes are non-callable until May 2004 and thereafter are callable at par, plus accrued interest plus a premium. The Notes were issued under an Indenture, dated May 29, 2001, between the Company and The Bank of New York, as Trustee. The Notes were issued to a limited number of purchasers in a private placement exempt from registration under Rule 144A under the Securities Act. The net proceeds to the Company was approximately \$314.5 million, which will be used for general corporate purposes, including capital expenditures and to meet working capital needs. The Notes may not be offered or sold in the United States absent registration with the SEC or the availability of an applicable exemption from such registration requirements. On June 28, 2001, the Company filed a registration statement with the SEC for the resale by holders of the Notes of their notes and the common stock issuable upon conversion of the Notes. The registration statement has not yet been declared effective.

On June 8, 2001, holders of an aggregate principal amount of \$30 million of our 6% convertible notes agreed to exchange such notes for an aggregate of 2,740,000 shares of common stock in exchanges exempt from registration pursuant to Section 3(a)(9) of the Securities Act of 1933.

On July 5, 2001, the Company adopted a stockholder rights plan. Under the rights plan, the Company issued a dividend of one right for each share of common stock of the Company held by stockholders of record at the close of business on July 17, 2001. Each right initially entitles the holder to purchase from the Company one one-thousandth of a share of a new series of participating preferred stock of the Company at an initial purchase price of \$50. The rights will become exercisable and will detach from the Company's common stock only upon the occurrence of certain events. Upon the occurrence of these events, unless redeemed for \$.01 per right, the rights will become exercisable by holders, other than rights held by a potential unsolicited third party acquiror, for shares of common stock of the Company or for shares of the third party acquiror having a value of twice the right's then-current purchase price. The rights will expire on July 9, 2011. See Current Report on Form 8-K filed on July 10, 2001.

Item 3. Defaults Upon Senior Securities—Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders—None

Item 5. Other Information—None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

<u>Exhibit Number</u>	
<u>*3.1</u>	Certificate of Designation of Series B Participating Cumulative Preferred Stock of the Company.
4.1	Indenture dated as of May 29, 2001 between the Company and The Bank of New York, as trustee (incorporated by reference to Exhibit 4.1 of the Company's Registration Statement on Form S-3, File No. 333-64102).
4.2	Officers' Certificate pursuant to Sections 2.1 and 2.2 of the Indenture referred to in Exhibit 4.1 (incorporated by reference to Exhibit 4.2 of the Company's Registration Statement on Form S-3, File No. 333-64102).
4.3	Form of Note (included in Exhibit 4.2).
4.4	Rights Agreement dated as of July 9, 2001 between the Company and American Stock Transfer and Trust Company, as Rights Agent (incorporated by reference to Exhibit 99.2 of the Company's Current Report on Form 8-K filed on July 10, 2001).
10.1	Form of Stock Pledge Agreement by and between the Company and Charles W. Thomson dated February 28, 2001
10.2	Form of Loan, Note and Stock Pledge Agreements by and between the Company and Pamela Kramer dated March 30, 2001
10.3	Form of Residential Lease with option to buy entered into between B.R.E. Holdings LLC, a wholly-owned subsidiary of the Company, and each of Jerry Gramaglia and Charles W. Thomson, as lessees
<u>*10.4</u>	Form of Loan and Note Agreements between the Company and Dennis Lundien, dated May 9, 2001.
<u>*10.5</u>	Form of Note and Stock Pledge Agreements between the Company and Christos M. Cotsakos, dated June 19, 2001.

* Filed herewith.

(b) Reports on Form 8-K

On May 21, 2001, the Company filed a Current Report on Form 8-K to report that it had entered into an Agreement and Plan of Merger to acquire Web Street, Inc., parent company of Web Street Securities, an online brokerage firm.

On May 22, 2001, the Company filed a Current Report on Form 8-K to report that it intended to sell approximately \$250 million in convertible subordinated notes in a private placement.

On June 15, 2001, the Company filed a Current Report on Form 8-K to report the final closing terms of its private placement of \$325 million of convertible subordinated notes and to report the potential write down of certain of its investments.

On July 10, 2001, the Company filed a Current Report on Form 8-K to report the adoption of its stockholder rights plan.

On July 24, 2001, the Company filed a Current Report on Form 8-K to report the announcement of its financial results for the quarter ended June 30, 2001.

SIGNATURES

Pursuant to the requirements 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.

E*TRADE Group, Inc.
(Registrant)

Dated: August 14, 2001

By _____ /s/ CHRISTOS M. COTSAKOS

Christos M. Cotsakos

*Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)*

/s/ LEONARD C. PURKIS

By

Leonard C. Purkis
Chief Financial Officer
(Principal Financial and Accounting Officer)

**CERTIFICATE OF DESIGNATION
OF
SERIES B PARTICIPATING CUMULATIVE
PREFERRED STOCK**

OF

E*TRADE Group, Inc.

Pursuant to Section 151 of the
General Corporation Law of the
State of Delaware

We, Christos M. Cotsakos, Chief Executive Officer, and Leonard C. Purkis, Chief Financial Officer, of E*TRADE Group, Inc., a corporation organized and existing under the General Corporation Law of the State of Delaware ("**Delaware Law**"), in accordance with the provisions thereof, DO HEREBY CERTIFY:

That pursuant to the authority conferred upon the Board of Directors by the Certificate of Incorporation of the Corporation, the Board of Directors on July 5, 2001, adopted the following resolution creating a series of Preferred Stock in the amount and having the designation, voting powers, preferences and relative, participating, optional and other special rights and qualifications, limitations and restrictions thereof as follows:

SECTION 1. Designation and Number of Shares. The shares of such series shall be designated as "Series B Participating Cumulative Preferred Stock" (the "**Series B Preferred Stock**"), and the number of shares constituting such series shall be 500,000. Such number of shares of the Series B Preferred Stock may be increased or decreased by resolution of the Board of Directors; *provided* that no decrease shall reduce the number of shares of Series B Preferred Stock to a number less than the number of shares then outstanding plus the number of shares issuable upon exercise or conversion of outstanding rights, options or other securities issued by the Corporation.

SECTION 2. Dividends and Distributions.

(a) The holders of shares of Series B Preferred Stock shall be entitled to receive, when, as and if declared by the Board of Directors out of funds legally available for the purpose, quarterly dividends payable on March 31, June 30, September 30 and December 31 of each year (each such date being referred to herein as a "**Quarterly Dividend Payment Date**"), commencing on the first Quarterly Dividend Payment Date after the first issuance of any share or fraction of a share of Series B Preferred Stock, in an amount per share (rounded to the nearest cent) equal to the greater of (i) \$1.00 and (ii) subject to the provision for adjustment hereinafter set forth, 1000 times the aggregate per share amount of all cash dividends or other distributions and 1000 times the aggregate per share amount of all non-cash dividends or other distributions (other than a (A) dividend payable in shares of Common Stock, par value \$.01 per share, of the Corporation (the "**Common Stock**") or (B) a subdivision of the outstanding shares of Common Stock (by reclassification or otherwise)), declared on the Common Stock since the immediately preceding Quarterly Dividend Payment Date, or, with respect to the first Quarterly Dividend Payment Date, since the first issuance of any share or fraction of a share of Series B Preferred Stock. If the Corporation shall at any time after July 5, 2001 (the "**Rights Declaration Date**") pay any dividend on Common Stock payable in shares of Common Stock or effect a subdivision or combination of the outstanding shares of Common Stock (by reclassification or otherwise) into a greater or lesser number of shares of Common Stock, then in each such case the amount to which holders of shares of Series B Preferred Stock were entitled immediately prior to such event under clause of the preceding sentence shall be adjusted by multiplying such amount by a fraction the numerator of which is the number of shares of Common Stock outstanding immediately after such event and the denominator of which is the number of shares of Common Stock that were outstanding immediately prior to such event.

(b) The Corporation shall declare a dividend or distribution on the Series B Preferred Stock as provided in paragraph 2(a) above immediately after it declares a dividend or distribution on the Common Stock (other than as described in clauses 2(a)(ii)(A) and (a)(ii)(B) above); *provided* that if no dividend or distribution shall have been declared on the Common Stock during the period between any Quarterly Dividend Payment Date and the next subsequent Quarterly Dividend Payment Date (or, with respect to the first Quarterly Dividend Payment Date, the period between the first issuance of any share or fraction of a share of Series B Preferred Stock and such first Quarterly Dividend Payment Date), a dividend of \$1.00 per share on the Series B Preferred Stock shall nevertheless be payable on such subsequent Quarterly Dividend Payment Date.

(c) Dividends shall begin to accrue and be cumulative on outstanding shares of Series B Preferred Stock from the Quarterly Dividend Payment Date next preceding the date of issue of such shares of Series B Preferred Stock, unless the date of issue of such shares is on or before the record date for the first Quarterly Dividend Payment Date, in which case dividends on such shares shall begin to accrue and be cumulative from the date of issue of such shares, or unless the date of issue is a date after the record date for the determination of holders of shares of Series B Preferred Stock entitled to receive a quarterly dividend and on or before such Quarterly Dividend Payment Date, in which case dividends shall begin to accrue and be cumulative from such Quarterly Dividend Payment Date. Accrued but unpaid dividends shall not bear interest. Dividends paid on shares of Series B Preferred Stock in an amount less than the total amount of such dividends at the time accrued and payable on such shares shall be allocated pro rata on a share-by-share basis among all such shares at the time outstanding. The Board of Directors may fix a record date for the determination of holders of shares of Series B Preferred Stock entitled to receive payment of a dividend or distribution declared thereon, which record date shall not be more than 60 days prior to the date fixed for the payment thereof.

SECTION 3. Voting Rights. In addition to any other voting rights required by law, the holders of shares of Series B Preferred Stock shall have the following voting rights:

(a) Subject to the provision for adjustment hereinafter set forth, each share of Series B Preferred Stock shall entitle the holder thereof to 1000 votes on all matters submitted to a vote of stockholders of the Corporation. If the Corporation shall at any time after the Rights Declaration Date pay any dividend on Common Stock payable in shares of Common Stock or effect a subdivision or combination of the outstanding shares of Common Stock (by reclassification or otherwise) into a greater or lesser number of shares of Common Stock, then in each such case the number of votes per share to which holders of shares of Series B Preferred Stock

were entitled immediately prior to such event shall be adjusted by multiplying such number by a fraction the numerator of which is the number of shares of Common Stock outstanding immediately after such event and the denominator of which is the number of shares of Common Stock that were outstanding immediately prior to such event.

(b) Except as otherwise provided herein or by law, the holders of shares of Series B Preferred Stock and the holders of shares of Common Stock shall vote together as a single class on all matters submitted to a vote of stockholders of the Corporation.

(c) (i) If at any time dividends on any Series B Preferred Stock shall be in arrears in an amount equal to six quarterly dividends thereon, the occurrence of such contingency shall mark the beginning of a period (herein called a “default period”) which shall extend until such time when all accrued and unpaid dividends for all previous quarterly dividend periods and for the current quarterly dividend period on all shares of Series B Preferred Stock then outstanding shall have been declared and paid or set apart for payment. During each default period, all holders of Preferred Stock and any other series of Preferred Stock then entitled as a class to elect directors, voting together as a single class, irrespective of series, shall have the right to elect two Directors.

(ii) During any default period, such voting right of the holders of Series B Preferred Stock may be exercised initially at a special meeting called pursuant to subparagraph 3(c)(iii) hereof or at any annual meeting of stockholders, and thereafter at annual meetings of stockholders, *provided* that neither such voting right nor the right of the holders of any other series of Preferred Stock, if any, to increase, in certain cases, the authorized number of Directors shall be exercised unless the holders of 10% in number of shares of Preferred Stock outstanding shall be present in person or by proxy. The absence of a quorum of holders of Common Stock shall not affect the exercise by holders of Preferred Stock of such voting right. At any meeting at which holders of Preferred Stock shall exercise such voting right initially during an existing default period, they shall have the right, voting as a class, to elect Directors to fill such vacancies, if any, in the Board of Directors as may then exist up to two Directors or, if such right is exercised at an annual meeting, to elect two Directors. If the number which may be so elected at any special meeting does not amount to the required number, the holders of the Preferred Stock shall have the right to make such increase in the number of Directors as shall be necessary to permit the election by them of the required number. After the holders of the Preferred Stock shall have exercised their right to elect Directors in any default period and during the continuance of such period, the number of Directors shall not be increased or decreased except by vote of the holders of Preferred Stock as herein provided or pursuant to the rights of any equity securities ranking senior to or *pari passu* with the Series B Preferred Stock.

(iii) Unless the holders of Preferred Stock shall, during an existing default period, have previously exercised their right to elect Directors, the Board of Directors may order, or any stockholder or stockholders owning in the aggregate not less than 10% of the total number of shares of Preferred Stock outstanding, irrespective of series, may request, the calling of special meeting of holders of Preferred Stock, which meeting shall thereupon be called by the President, a Vice President or the Secretary of the Corporation. Notice of such meeting and of any annual meeting at which holders of Preferred Stock are entitled to vote pursuant to this paragraph 3(c)(iii) shall be given to each holder of record of Preferred Stock by mailing a copy of such notice to him at his last address as the same appears on the books of the Corporation. Such meeting shall be called for a time not earlier than 20 days and not later than 60 days after such order or request or in default of the calling of such meeting within 60 days after such order or request, such meeting may be called on similar notice by any stockholder or stockholders owning in the aggregate not less than 10% of the total number of shares of Preferred Stock outstanding, irrespective of series. Notwithstanding the provisions of this paragraph 3(c)(iii), no such special meeting shall be called during the period within 60 days immediately preceding the date fixed for the next annual meeting of stockholders.

(iv) In any default period, the holders of Common Stock, and other classes of stock of the Corporation if applicable, shall continue to be entitled to elect the whole number of Directors until the holders of Preferred Stock shall have exercised their right to elect two Directors voting as a class, after the exercise of which right (x) the Directors so elected by the holders of Preferred Stock shall continue in office until their successors shall have been elected by such holders or until the expiration of the default period, and (y) any vacancy in the Board of Directors may (except as provided in paragraph 3(c)(iii) hereof) be filled by vote of a majority of the remaining Directors theretofore elected by the holders of the class of stock which elected the Director whose office shall have become vacant. References in this paragraph 3(c) to Directors elected by the holders of a particular class of stock shall include Directors elected by such Directors to fill vacancies as provided in clause (y) of the foregoing sentence.

(v) Immediately upon the expiration of a default period, (x) the right of the holders of Preferred Stock as a class to elect Directors shall cease, (y) the term of any Directors elected by the holders of Preferred Stock as a class shall terminate, and (z) the number of Directors shall be such number as may be provided for in the certificate of incorporation or bylaws irrespective of any increase made pursuant to the provisions of paragraph 3(c)(iii) hereof (such number being subject, however, to change thereafter in any manner provided by law or in the certificate of incorporation or bylaws). Any vacancies in the Board of Directors effected by the provisions of clauses (y) and (z) in the preceding sentence may be filled by a majority of the remaining Directors.

(d) The Certificate of Incorporation of the Corporation shall not be amended in any manner (whether by merger or otherwise) so as to adversely affect the powers, preferences or special rights of the Series B Preferred Stock without the affirmative vote of the holders of a majority of the outstanding shares of Series B Preferred Stock, voting separately as a class.

(e) Except as otherwise provided herein, holders of Series B Preferred Stock shall have no special voting rights, and their consent shall not be required for taking any corporate action.

SECTION 4. *Certain Restrictions.*

(a) Whenever quarterly dividends or other dividends or distributions payable on the Series B Preferred Stock as provided in Section are in arrears, thereafter and until all accrued and unpaid dividends and distributions, whether or not declared, on outstanding shares of Series B Preferred Stock shall have been paid in full, the Corporation shall not:

(i) declare or pay dividends on, or make any other distributions on, any shares of stock ranking junior (either as to dividends or upon liquidation, dissolution or winding up) to the Series B Preferred Stock;

(ii) declare or pay dividends on, or make any other distributions on, any shares of stock ranking on a parity (either as to dividends or upon liquidation, dissolution or winding up) with the Series B Preferred Stock, except dividends paid ratably on the Series B Preferred Stock and all such other parity stock on which dividends are payable or in arrears in proportion to the total amounts to which the holders of all such shares are then entitled;

(iii) redeem, purchase or otherwise acquire for value any shares of stock ranking junior (either as to dividends or upon liquidation, dissolution or winding up) to the Series B Preferred Stock; *provided* that the Corporation may at any time redeem, purchase or otherwise acquire shares of any such junior stock in exchange for shares of stock of the Corporation ranking junior (as to dividends and upon dissolution, liquidation or winding up) to the Series B Preferred Stock; or

(iv) redeem, purchase or otherwise acquire for value any shares of Series B Preferred Stock, or any shares of stock ranking on a parity (either as to dividends or upon liquidation, dissolution or winding up) with the Series B Preferred Stock, except in accordance with a purchase offer made in writing or by publication (as determined by the Board of Directors) to all holders of Series B Preferred Stock and all such other parity stock upon such terms as the Board of Directors, after consideration of the respective annual dividend rates and other relative rights and preferences of the respective series and classes, shall determine in good faith will result in fair and equitable treatment among the respective series or classes.

(b) The Corporation shall not permit any subsidiary of the Corporation to purchase or otherwise acquire for value any shares of stock of the Corporation unless the Corporation could, under paragraph 4(a), purchase or otherwise acquire such shares at such time and in such manner.

SECTION 5. *Reacquired Shares.* Any shares of Series B Preferred Stock redeemed, purchased or otherwise acquired by the Corporation in any manner whatsoever shall be retired and cancelled promptly after the acquisition thereof. All such shares shall upon their cancellation become authorized but unissued shares of Preferred Stock without designation as to series and may be reissued as part of a new series of Preferred Stock to be created by resolution or resolutions of the Board of Directors as permitted by the Certificate of Incorporation or as otherwise permitted under Delaware Law.

SECTION 6. *Liquidation, Dissolution and Winding Up.* Upon any liquidation, dissolution or winding up of the Corporation, no distribution shall be made (1) to the holders of shares of stock ranking junior (either as to dividends or upon liquidation, dissolution or winding up) to the Series B Preferred Stock unless, prior thereto, the holders of shares of Series B Preferred Stock shall have received \$1.00 per share, plus an amount equal to accrued and unpaid dividends and distributions thereon, whether or not declared, to the date of such payment; *provided* that the holders of shares of Series B Preferred Stock shall be entitled to receive an aggregate amount per share, subject to the provision for adjustment hereinafter set forth, equal to 1000 times the aggregate amount to be distributed per share to holders of Common Stock, or (2) to the holders of stock ranking on a parity (either as to dividends or upon liquidation, dissolution or winding up) with the Series B Preferred Stock, except distributions made ratably on the Series B Preferred Stock and all such other parity stock in proportion to the total amounts to which the holders of all such shares are entitled upon such liquidation, dissolution or winding up. If the Corporation shall at any time after the Rights Declaration Date pay any dividend on Common Stock payable in shares of Common Stock or effect a subdivision or combination of the outstanding shares of Common Stock (by reclassification or otherwise) into a greater or lesser number of shares of Common Stock, then in each such case the aggregate amount to which holders of shares of Series B Preferred Stock were entitled immediately prior to such event under the proviso in clause (1) of the preceding sentence shall be adjusted by multiplying such amount by a fraction the numerator of which is the number of shares of Common Stock outstanding immediately after such event and the denominator of which is the number of shares of Common Stock that were outstanding immediately prior to such event.

SECTION 7. *Consolidation, Merger, Etc.* If the Corporation shall enter into any consolidation, merger, combination or other transaction in which the shares of Common Stock are exchanged for or changed into other stock or securities, cash or any other property, then in any such case the shares of Series B Preferred Stock shall at the same time be similarly exchanged for or changed into an amount per share, subject to the provision for adjustment hereinafter set forth, equal to 1000 times the aggregate amount of stock, securities, cash or any other property, as the case may be, into which or for which each share of Common Stock is changed or exchanged. If the Corporation shall at any time after the Rights Declaration Date pay any dividend on Common Stock payable in shares of Common Stock or effect a subdivision or combination of the outstanding shares of Common Stock (by reclassification or otherwise) into a greater or lesser number of shares of Common Stock, then in each such case the amount set forth in the preceding sentence with respect to the exchange or change of shares of Series B Preferred Stock shall be adjusted by multiplying such amount by a fraction the numerator of which is the number of shares of Common Stock outstanding immediately after such event and the denominator of which is the number of shares of Common Stock that were outstanding immediately prior to such event.

SECTION 8. *No Redemption.* The Series B Preferred Stock shall not be redeemable.

SECTION 9. *Rank.* The Series B Preferred Stock shall rank junior (as to dividends and upon liquidation, dissolution and winding up) to all other series of the Corporation's preferred stock except any series that specifically provides that such series shall rank junior to the Series B Preferred Stock.

SECTION 10. *Fractional Shares.* Series B Preferred Stock may be issued in fractions of a share which shall entitle the holder, in proportion to such holder's fractional shares, to exercise voting rights, receive dividends, participate in distributions and to have the benefit of all other rights of holders of Series B Preferred Stock.

IN WITNESS WHEREOF, we have executed and subscribed this Certificate this 9th day of July, 2001.

/s/ Christos M. Cotsakos

Christos M. Cotsakos
Chief Executive Officer

Attest:

/s/ Leonard C. Purkis

Leonard C. Purkis
Chief Financial Officer

LOAN AGREEMENT

This Loan Agreement ("Agreement") is made this 9th day of May 2001, by and between Dennis Lundien and Deborah Lundien ("Borrower") and E*TRADE Group, Inc., a Delaware corporation ("Lender").

1. **Loan Agreement.** Subject to the terms and conditions of this Agreement, Lender agrees to make to Borrower, and Borrower agrees to accept from Lender, a loan (the "Loan") in the principal amount of Two Million Dollars (\$2,000,000).

2. **Loan Terms.** The Loan shall be evidenced by a Note Secured by Deed of Trust in the form of Exhibit A to this Agreement (the "Note") and will be secured by a Deed of Trust and Assignment of Rents covering certain real property commonly known as 120 Atherton Avenue, Atherton, California, together with all improvements now or hereafter located thereon (the "Property"). The Loan shall bear interest at the rate per annum specified in the Note and Borrower shall pay the Note in accordance with the terms thereof. This Loan is a bridge loan to facilitate the purchase of a new principal residence for Borrower pending sale of Borrower's former principal residence. Accordingly, the proceeds of this Loan shall be applied solely to the purchase of Borrower's principal residence at 7120 Summerwood Court, Granite Bay, California, and for improvements to said property.

3. **Conditions Precedent to Closing of Loan.** As conditions precedent to Lender's obligation to close the Loan and disburse and Loan proceeds, on or before the Closing Date, (a) Borrower shall deliver the documents described in subsections (i), (ii) and (iii), each duly executed and acknowledged by a notary public, where necessary, and in form and substance satisfactory to Lender (the "Loan Documents"), and (b) Lender shall have obtained the items described in subsections (iv) and (v):

- (i) This Agreement.
- (ii) The Note.
- (iii) The Deed of Trust executed by Borrower as Trustor to North American Title Insurance Company, a California corporation, as Trustee, and naming Lender as Beneficiary, to be recorded on the Closing Date in the Official Records of San Mateo County, California.
- (iv) An ALTA title insurance policy insuring Lender that the Deed of Trust constitutes a valid and enforceable lien on the Property subject and subordinate only to such liens or other matters as Lender has approved in writing.
- (v) An appraisal of the Property, in form acceptable to Lender, indicating that the loan to value ratio of the monetary liens described herein will be acceptable to Lender (the "Appraisal").

4. **Closing and Funding of Loan.** Funding of the Loan proceeds by Lender (the "Closing") shall be contingent upon delivery of the Loan Documents, to a custodian designated by Lender, and confirmation by the custodian that it has possession of all documents required herein. Such confirmation shall occur and the Loan shall be funded not later than May 31, 2001 (the "Closing Date").

5. **Notices.** All notices, requests, demands, and other communications required or permitted to be given under this Agreement shall be in writing and shall be sent by United States mail, postage prepaid, certified return receipt requested, or by personal delivery, or by overnight courier, addressed to the other party as set forth below or at such other places as may be designated in notice to the other party given as provided herein. Notice shall be deemed effective upon actual receipt, if personally delivered, one business day following deposit with Federal Express or other reputable, national overnight courier that provides a receipt, or on the third day following deposit in the United States mail in the manner described above.

Borrower:
Dennis and Deborah Lundien
7120 Summerwood Ct.
Granite Bay, CA 95746

Lender:
E*TRADE Group, Inc.
4500 Bohannon Drive
Menlo Park, CA 94025
Attention: Theodore J. Theophilos

6. **Loan Not to Affect Employment.** Borrower agrees and understands that nothing in this Agreement shall confer any right with respect to the continuation of the employment of Dennis Lundien with Lender or any of its subsidiaries, nor shall this Agreement interfere in any way with his right or Lender's right to terminate Dennis Lundien's employment at any time, with or without cause, in accordance with his employment agreement with Lender (the "Employment Agreement").

7. **Entire Agreement.** The foregoing and the Loan Documents constitute the entire agreement between the parties regarding the Loan and may be modified only by writing signed by Borrower and Lender. There are no agreements, representations, or warranties between the parties with regard to the Loan other than those expressly set forth in this Agreement.

8. **Representation of the Parties.** Borrower acknowledges that (i) they have been advised by attorneys for Lender to consult with their independent legal, tax and financial counsel about the terms of this Loan, and (ii) they have had an adequate opportunity to consult with such separate counsel before executing this Agreement.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date first above written.

Borrower:

Lender:
E*TRADE Group, Inc.

/s/ DENNIS LUNDIEN

Dennis Lundien

By /s/ RUSSELL S. ELMER

Title: Chief People and Culture Officer

/s/ DEBORAH LUNDIEN

Deborah Lundien

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EXHIBIT A

FORM OF NOTE SECURED BY DEED OF TRUST

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E*TRADE GROUP, INC.

NOTE SECURED BY DEED OF TRUST

\$2,000,000

May 9, 2001
Menlo Park, California

FOR VALUE RECEIVED, Dennis Lundien and Deborah Lundien, as husband and wife (jointly and severally, the "Maker"), promise to pay to the order of E*TRADE Group, Inc., a Delaware corporation (the "Corporation"), at its corporate offices at 4500 Bohannon Drive, Menlo Park, CA 94025, the principal sum of Two Million Dollars (\$2,000,000), together with all accrued interest thereon, upon the terms and conditions specified below.

1. Interest. Interest shall accrue on the unpaid balance outstanding from time to time under this Note at the rate of Four and Twenty-Five One Hundredths Percent (4.25%) per annum, compounded annually. All computations of interest shall be made on the basis of a year of 360 days for the actual number of days (including the first day but excluding the last day) occurring in the period for which such interest is payable. All accrued and unpaid interest shall become due and payable in one lump sum on the due date for the payment of the principal balance of this Note.

2. Maturity Date. The entire principal balance of this Note, together with all accrued and unpaid interest, shall become due and payable in one lump sum on May 31, 2002 or the date of the closing of the sale of the Collateral, as such term is defined in paragraph 4 of this Note, whichever first occurs.

3. Payment. All payments of principal and interest on this Note shall be made without offset or deduction and shall be made in immediately available lawful tender of the United States and shall be applied first to the payment of all accrued and unpaid interest and then to the payment of principal. Prepayment of the principal balance of this Note, together with all accrued and unpaid interest, may be made in whole or in part at any time without penalty.

4. Collateral. Payment of this Note shall be secured by a Deed of Trust With Assignment of Rents, of even date herewith (the "Deed of Trust"), covering the fee simple estate of Maker in the property and improvements located at 120 Atherton Avenue, Atherton, California, as such property is more particularly described in Exhibit "A" to the Deed of Trust (the "Collateral").

5. Representations and Warranties. The Maker hereby represents and warrants to the Corporation that this Note does not contravene any contractual or judicial restriction binding on or affecting the Maker and that this Note is the legal, valid and binding obligation of the Maker enforceable against the Maker in accordance with its terms.

6. Notice. The Maker agrees to notify the Corporation of the incurrence of any other indebtedness secured by the Collateral prior to the incurrence thereof.

7. Events of Acceleration. The entire unpaid principal balance of this Note, together with all accrued and unpaid interest, shall become immediately due and payable prior to the specified due date of this Note upon the occurrence of one or more of the following events:

a. The breach of any representation or covenant under this Note, the Loan Agreement (as defined below), or the Deed of Trust ;

b. The filing of a petition by or against the Maker under any provision of the Bankruptcy Reform Act, Title 11 of the United States Code, as amended or recodified from time to time, or under any similar law relating to bankruptcy, insolvency or other relief for debtors and the continuation of such petition without dismissal for a period of thirty (30) days or more; or appointment of a receiver, trustee, custodian or liquidator of or for all or any part of the assets or property of the Maker; or the insolvency of the Maker; or the making of a general assignment for the benefit of creditors by the Maker;

c. The death or incapacity of Dennis Lundien;

d. The Deed of Trust or any other document relating to this Note and the Collateral after delivery thereof shall for any reason be revoked or invalidated, or otherwise cease to be in full force and effect, or the Maker or any other person shall contest in any manner the validity or enforceability thereof, or the Maker or any other person shall deny that it has any further liability or obligation thereunder; or any of the documents relating to the Collateral for any reason, except to the extent permitted by the terms thereof, shall cease to create a valid and perfected second priority lien in any of the Collateral purported to be covered thereby;

e. The sale, transfer, mortgage, assignment, encumbrance or lease, whether voluntarily or involuntarily or by operation of law or otherwise, of the Collateral, or any portion thereof or interest therein, without the prior written consent of the Corporation; or

- f. The incurrence by the Maker of any other indebtedness secured by the Collateral which has not been consented to by the Corporation;
- g. The expiration of the two (2)-month period following the date Dennis Lundien ceases for any reason to remain in the Corporation's employ;
- h. The occurrence of any event of default under this Note, the Deed of Trust, the Loan Agreement, or of any obligation secured thereby.

8. Default. Upon and after the occurrence of a default hereunder or any other agreement or instrument evidencing, governing or securing this Note (an "Event of Default"), the Loan shall bear interest, payable upon demand, at the **lesser** of (i) the rate of ten percent (10%) per annum, compounded annually, or the maximum rate allowed by law (the "Default Rate").

9. Employment. For purposes of applying the provisions of this Note, Dennis Lundien shall be considered to remain in the Corporation's employ for so long as he renders services as a full-time employee of the Corporation, any successor entity or one or more of the Corporation's fifty percent (50%)-or-more owned (directly or indirectly) subsidiaries.

10. Collection. The Maker agrees to pay on demand all the losses, costs, and expenses (including, without limitation, attorneys' fees and disbursements) which the Corporation incurs in connection with enforcement or attempted enforcement of this Note, or the protection or preservation of the Corporation's rights under this Note, whether by judicial proceedings or otherwise. Such costs and expenses include, without limitation, those incurred in connection with any workout or refinancing, or any bankruptcy, insolvency, liquidation or similar proceedings.

11. Waivers.

a. A waiver of any term of this Note, the Loan Agreement, the Deed of Trust or of any of the obligations secured thereby must be made in writing and signed by a duly-authorized officer of the Corporation and any such waiver shall be limited to its express terms. No delay by the Corporation in acting with respect to the terms of this Note, the Loan Agreement, or the Deed of Trust shall constitute a waiver of any breach, default, or failure of a condition under this Note, the Deed of Trust or the obligations secured thereby. No single or partial exercise of any power under this Note shall preclude any other or further exercise of such power or exercise of any other power.

b. The Maker waives presentment, demand, notice of dishonor, notice of default or delinquency, notice of acceleration, notice of protest and nonpayment, notice of costs, expenses or losses and interest thereon, notice of interest on interest and diligence in taking any action to collect any sums owing under this Note or in proceeding against any of the rights or interests in or to properties securing payment of this Note. The Maker agrees to make all payments under this Note without set-off of deduction and regardless of any counterclaim or defense.

12. Conflicting Agreements. In the event of any inconsistencies between the terms of this Note and the terms of any other document related to the loan evidenced by the Note, the terms of this Note shall prevail.

13. Governing Law. This Note shall be construed in accordance with the laws of the State of California. This Note shall be binding on the Maker and the Maker's personal representatives, heirs, and legatees, and shall be binding upon and inure to the benefit of the Corporation, any future holder of this Note and their respective successors and assigns. The Maker may not assign or transfer this Note or any of the Maker's obligations hereunder without the Corporation's prior written consent.

14. Loan Agreement. This Note is subject to the provisions of that certain Loan Agreement between Maker and the Corporation, of even date herewith (the "Loan Agreement").

15. No Below Market Loan. Notwithstanding anything to the contrary contained in this Note, the Loan Agreement or the Deed of Trust, the interest rate applicable to this Note shall be not less than the Applicable Federal Rate set by the U.S. Treasury for determining below market loans pursuant to Section 7872 of the Internal Revenue Code of 1986, as now in effect (the "Internal Revenue Code"). This Note is not intended to be a "below market loan" as such term is used in Section 7872 of the Internal Revenue Code or any comparable applicable state tax law ("Below Market Loan"). The undersigned hereby agree that if any court or governmental taxing authority having jurisdiction over Maker or the Corporation shall determine that this Note is a Below Market Loan, the interest rate payable under this Note shall then be increased to the extent necessary to remove this Note from any otherwise applicable definition of a Below Market Loan.

16. Due On Sale. IF THE MAKER SHALL SELL, CONVEY OR ALIENATE THE PROPERTY COVERED BY THE DEED OF TRUST, OR ANY PART THEREOF, OR ANY INTEREST THEREIN, OR SHALL BE DIVESTED OF MAKER'S TITLE OR ANY INTEREST THEREIN IN ANY MANNER OR WAY, WHETHER VOLUNTARILY OR INVOLUNTARILY, WITHOUT THE WRITTEN CONSENT OF THE CORPORATION BEING FIRST HAD AND OBTAINED, THE CORPORATION SHALL HAVE THE RIGHT, AT ITS OPTION, EXCEPT AS PROHIBITED BY LAW, TO DECLARE THE INDEBTEDNESS AND OBLIGATIONS EVIDENCED BY THIS NOTE, IRRESPECTIVE OF THE MATURITY DATE SPECIFIED HEREIN, IMMEDIATELY DUE AND PAYABLE. CONSENT TO ONE SUCH TRANSACTION SHALL NOT BE DEEMED TO BE A WAIVER OF THE RIGHT TO REQUIRE SUCH CONSENT TO FUTURE SUCCESSIVE TRANSACTIONS.

MAKER

/s/ DENNIS LUNDIEN

Dennis Lundien

/s/ DEBORAH LUNDIEN

Deborah Lundien

**RECORDING REQUESTED BY
AND WHEN RECORDED MAIL TO**

NAME: E*TRADE Group, Inc.

ADDRESS: 4500 Bohannon Drive

CITY: Menlo Park

STATE & ZIP: California 94025

LONG FORM DEED OF TRUST AND ASSIGNMENT OF RENTS (INDIVIDUAL)

APN NO. 070-080-120

This Deed of Trust, made this 9th day of May, 2001, between Deborah Lundien and Dennis Lundien, herein called Trustor, whose address is 120 Atherton Avenue, Atherton, California, North American Title Company, Inc., herein called Trustee, and E*TRADE Group, Inc., a Delaware Corporation, herein called Beneficiary,

Witnesseth: That Trustor **IRREVOCABLY GRANTS, TRANSFERS AND ASSIGNS TO TRUSTEE IN TRUST, WITH POWER OF SALE**, that property in San Mateo County, California, described as:

See Exhibit A Attached Hereto and Incorporated Herein By This Reference

TOGETHER WITH the rents, issues and profits thereof, SUBJECT, HOWEVER, to the right, power and authority given to and conferred upon Beneficiary by paragraph (10) of the provisions herein to collect and apply such rents, issues and profits. **For the Purpose of Securing:** 1. Performance of each agreement of Trustor incorporated by reference or contained herein. 2. Payment of the indebtedness evidenced by one promissory note of even date herewith, and any extension or renewal thereof, in the principal sum of \$2,000,000.00 executed by Trustor in favor of Beneficiary or order. 3. Payment of such further sums as the then record owner of said property may borrow from Beneficiary, when evidenced by another note (or notes) reciting it is so secured.

To Protect the Security of This Deed of Trust, Trustor Agrees:

(1) To keep said property in good condition and repair, not to remove or demolish any building thereon, to complete or restore promptly and in good and workmanlike manner any building which may be constructed, damaged or destroyed thereon and to pay when due all claims for labor performed and materials furnished therefor, to comply with all laws affecting said property or requiring any alterations or improvements to be made thereon, not to commit or permit waste thereof, not to commit, suffer or permit any act upon said property in violations of law to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of said property may be reasonably necessary, the specific enumerations herein not excluding the general (2) To provide maintain and deliver to Beneficiary fire insurance satisfactory to and with loss payable to Beneficiary. The amount collected under any fire or other insurance policy may be applied by Beneficiary upon indebtedness secured hereby and in such order as Beneficiary may determine, or at option of Beneficiary the entire amount so collected or any part thereof may be released to Trustor. Such application or release shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice.

(3) To appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee, and to pay all costs and expenses including cost of evidence of title and attorney's fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear, and in any suit brought by Beneficiary to foreclose this Deed.

(4) To pay at least ten days before delinquency all taxes and assessments affecting said property, including assessments on appurtenant water stock, when due, all encumbrances, charges and liens, with interest, on said property or any part thereof, which appear to be prior or superior hereto, all costs, fees and expenses of this Trust.

Should Trustor fail to make any payment or to do any act as herein provided, then Beneficiary or Trustee, but without obligation so to do and without notice to or demand upon Trustor and without releasing Trustor from any obligation hereof, may make or do the same in such manner and to such extent as either may deem necessary to protect the security hereof Beneficiary or Trustee being authorized to enter upon said property for such purposes; appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee, pay, purchase, contest or compromise any encumbrance, charge or lien which in the judgment of either appears to be prior or superior hereto, and in exercising any such powers, pay necessary expenses, employ counsel and pay his reasonable fees.

(5) To pay immediately and without demand all sums so expended by Beneficiary or Trustee, with interest from date of expenditure at the amount allowed by law in effect at the date hereof, and to pay for any statement provided for by law in effect at the date hereof regarding the obligation secured hereby any amount demanded by the Beneficiary not to exceed the maximum allowed by law at the time when said statement is demanded.

(6) That any award of damages in connection with any condemnation for public use of or injury to said property or any part thereof is hereby assigned and shall be paid to Beneficiary who may apply or release such moneys received by him in the same manner and with the same effect as above provided for disposition of proceeds of fire or other insurance.

(7) That by accepting payment of any sum secured hereby after its due date, Beneficiary does not waive his rights either to require prompt payment when due of all other sums so secured or to declare default for failure so to pay.

(8) That at any time or from time to time, without liability therefor and without notice, upon written request of Beneficiary and presentation of

this Deed and said note for endorsement, and without affecting the personal liability of any person for payment of the indebtedness secured hereby. Trustee may reconvey any part of said property, consent to the making of any map or plot thereof; join in granting any easement thereon; or join in any extension agreement or any agreement subordinating the lien or charge hereof.

(9) That upon written request of Beneficiary state that all sums secured hereby have been paid, and upon surrender of this Deed and said note to Trustee for cancellation and retention and upon payment of its fees, Trustee shall reconvey, without warranty, the property then held hereunder. The recitals in such reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof. The grantee in such reconveyance may be described as "The person or persons legally entitled thereto" Five years after issuance of such full reconveyance, Trustee may destroy said note and this Deed (unless directed in such request to retain them).

(10) That as additional security, Trustor hereby give to and confers upon Beneficiary the right, power and authority, during the continuance of these Trusts, to collect the rents, issues and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, to collect the rents, issues and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, to collect and retain such rents, issues and profits as they become due and payable. Upon any such default, Beneficiary may at any time without notice, either in person, by agent, or by a receiver to be appointed by a court, and without regard to the adequacy of any security for the indebtedness hereby secured, enter upon and take possession of said property or any part thereof, in his own name sue for or otherwise collect such rents, issues and profits, including those past due and unpaid, and apply the same, less costs and expenses of operation and collection, including reasonable attorney's fees. Upon any indebtedness secured hereby, and in such order as Beneficiary may determine. The entering upon and taking possession of said property, the collection of such rents, issues and profits and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice.

(11) That upon default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder. Beneficiary may declare all sums secured hereby immediately due and payable by delivery to Trustee of written declaration of default and demand for sale and of written notice of default and of election to cause to be sold said property which notice Trustee shall cause to be filed for record. Beneficiary also shall deposit with Trustee this Deed, said note and all documents evidencing expenditures secured hereby.

After the lapse of such time as may then be required by law following the recordation of said notice of default, and notice of sale having been given as then required by law, Trustee, without demand on Trustor, shall sell said property at the time and place fixed by it in said notice of sale, either as a whole or in separate parcels, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States, payable at time of sale. Trustee may postpone sale of all or any portion of said property by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement at the time fixed by the preceding postponement Trustee shall deliver to such purchaser its deed conveying the property so sold, but without any covenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be conclusive proof of the truthfulness thereof. Any person, including Trustor, Trustee, or Beneficiary as hereinafter defined, may purchase at such sale.

After deducting all costs, fees and expenses of Trustee and of this Trust, including cost of evidence of title in connection with sale, Trustee shall apply the proceeds of sale to payment of all sums expended under the terms hereof, not then repaid, with accrued interest at the amount allowed by law in effect at the date hereof, all other sums then secured hereby, and the remainder, if any, to the person or persons legally entitled thereto.

(12) Beneficiary, or any successor in ownership of any indebtedness secured hereby, may from time to time, by instrument in writing, substitute a successor or successors to any Trustee named herein or acting hereunder, which instrument, executed by the Beneficiary and duly acknowledged and recorded in the office of the recorder of the county or counties where said property is situated, shall be conclusive proof of proper substitution of such successor Trustee or Trustees, who shall, without conveyance from the Trustee predecessor, succeed to all its title, estate, rights, powers and duties. Said instrument must contain the name of the original Trustor, Trustee and Beneficiary hereunder, the book and page where this Deed is recorded and the name and address of the new Trustee.

(13) That this Deed applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary shall mean the owner and holder, including pledgees, of the note secured hereby whether or not named as Beneficiary herein in this Deed, whenever the context so requires, the masculine gender includes the feminine and/or neuter, and the singular number includes the plural.

(14) That Trustee accepts this Trust when this Deed, duly executed and acknowledged, is made a public record as provided by law. Trustee is not obligated to notify any party hereto of pending sale under any other Deed of Trust or of any action or proceeding in which Trustor, Beneficiary or Trustee shall be a party unless brought by Trustee.

The undersigned Trustor requests that a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to them at their address hereinbefore set forth.

IF THE TRUSTOR SHALL SELL, CONVEY OR ALIENATE SAID PROPERTY, OR ANY PART THEREOF, OR ANY INTEREST THEREIN, OR SHALL BE DIVESTED OF THEIR TITLE OR ANY INTEREST THEREIN IN ANY MANNER OR WAY, WHETHER VOLUNTARILY OR INVOLUNTARILY, WITHOUT THE WRITTEN CONSENT OF THE BENEFICIARY BEING FIRST HAD AND OBTAINED, BENEFICIARY SHALL HAVE THE RIGHT, AT ITS OPTION, EXCEPT AS PROHIBITED BY LAW, TO DECLARE ANY INDEBTEDNESS OR OBLIGATIONS SECURED HEREBY, IRRESPECTIVE OF THE MATURITY DATE SPECIFIED IN ANY NOTE EVIDENCING THE SAME, IMMEDIATELY DUE AND PAYABLE.

/s/ DENNIS LUNDIEN

Dennis Lundien

/s/ DEBORAH LUNDIEN

Deborah Lundien

EXHIBIT A

Deed of Trust and Assignment of Rents

The property referred to herein is situated in the State of California, County of SAN MATEO, TOWN OF ATHERTON, described as follows:

PORTION OF LOT LETTERED "E", AS DESIGNATED ON THAT CERTAIN MAP ENTITLED, "MAP OF THE PARTITION OF THE SELBY TRACT, ATHERTON, SAN MATEO COUNTY, CALIFORNIA", WHICH MAP WAS FILED IN THE OFFICE OF THE RECORDER OF THE COUNTY OF SAN MATEO, STATE OF CALIFORNIA ON MARCH 2, 1920, IN BOOK 10 OF MAPS AT PAGES 29 AND 30, MORE PARTICULARLY DESCRIBED AS FOLLOWS:

BEGINNING AT A POINT ON THE NORTHWESTERLY LINE OF ATHERTON AVENUE, DISTANT THEREON 438 FEET SOUTHWESTERLY FROM THE MOST EASTERLY CORNER OF LOT LETTERED "E" AS SHOWN ON THE MAP ABOVE MENTIONED; THENCE FROM SAID POINT OF BEGINNING ALONG SAID NORTHWESTERLY LINE OF ATHERTON AVENUE, SOUTH 32°05' WEST 20 FEET; THENCE, NORTH 57°55' WEST 223 FEET; THENCE SOUTH 32°05' WEST 154 FEET; THENCE NORTH 57°55' WEST 202 FEET; THENCE NORTH 32°05' EAST 204 FEET; THENCE SOUTH 57°55' EAST 425 FEET TO THE POINT OF BEGINNING

A.P.N. 070-080-120

J.P.N. 070-008-080-12-A

E*TRADE GROUP, INC.**NOTE SECURED BY STOCK PLEDGE AGREEMENT**

\$12,500,000

June 19, 2001
Menlo Park, California

FOR VALUE RECEIVED, Christos M. Cotsakos ("Maker") promises to pay to the order of E*TRADE Group, Inc., a Delaware corporation (the "Corporation"), at its corporate offices at 4500 Bohannon Drive, Menlo Park, California 94025, the principal sum of Twelve Million Five Hundred Thousand Dollars (\$12,500,000), together with all accrued interest thereon, upon the terms and conditions specified below.

1. **Purchase Money Indebtedness.** The proceeds of this Note shall be applied solely and exclusively to the payment of the purchase price of Two Million Five Hundred Ten Thousand, Three Hundred Twenty-three (2,510,323) shares of the Corporation's common stock acquired this day by Maker (the "Purchased Shares"), together with all associated taxes, and those Purchased Shares shall be held in pledge by the Corporation as collateral for the payment of this Note.

2. **Interest.** Interest shall accrue on the unpaid balance outstanding from time to time under this Note at the rate of 7.5% per annum, compounded semi-annually. Accrued and unpaid interest as of June 19, 2002 shall become due and payable on June 19, 2002.

3. **Principal Due Date.** Subject to the accelerated payment provisions of Paragraph 5 and 6 of this Note, the principal balance of this Note shall become due and payable in one lump sum on July 19, 2002.

4. **Payment.** Payment shall be made in lawful tender of the United States and shall be applied first to the payment of all accrued and unpaid interest and then to the payment of principal. Prepayment of the principal balance of this Note, together with all accrued and unpaid interest on the portion of principal so prepaid, may be made in whole or in part at any time without penalty.

5. **Events of Acceleration.** The entire unpaid principal balance of this Note, together with all accrued and unpaid interest, shall become immediately due and payable prior to the specified due date of this Note upon the occurrence of one or more of the following events:

A. the failure of the Maker to pay any installment of principal or accrued interest under this Note when due and the continuation of such default for more than thirty (30) days; or

B. the expiration of the thirty (30)-day period following the date the Maker ceases for any reason to remain in the employ of the Corporation; or

C. the insolvency of the Maker, the commission of any act of bankruptcy by the Maker, the execution by the Maker of a general assignment for the benefit of creditors, the filing by or against the Maker of any petition in bankruptcy or any petition for relief under the provisions of the Federal bankruptcy act or any other state or Federal law for the relief of debtors and the continuation of such petition without dismissal for a period of thirty (30) days or more, the appointment of a receiver or trustee to take possession of any property or assets of the Maker or the attachment of or execution against any property or assets of the Maker; or

D. an acquisition of the Company (whether by merger, sale of all or substantially all of the Company's assets or sale of more than fifty percent (50%) of the Company's outstanding voting securities) for consideration payable in cash or freely-tradable securities; provided, however, that if the Pooling of Interest Method, as described in Accounting Principles Board Opinion No. 16, is used to account for the acquisition for financial accounting purposes, then acceleration of this Note shall not occur until the end of the sixty (60)-day period immediately following the close of the applicable transfer restriction period required under Accounting Series Release Numbers 130 and 135 and further provided that any contrary provision in any employment agreement or action by the Company's compensation committee shall supercede this provision; or

E. the occurrence of any event of default under the Stock Pledge Agreement securing this Note or any obligation secured thereby.

6. **Special Acceleration Event.** In the event the Maker sells or otherwise transfers for value one or more shares of the Corporation's common stock purchased with the proceeds of this Note, then any unpaid portion of the principal balance of this Note attributable to the purchase price of those shares shall become immediately due and payable, together with all accrued and unpaid interest on that principal portion.

7. **Employment.** The Maker shall be deemed to continue in employment with the Corporation for so long as he or she renders services as an employee of the Corporation or one or more of the Corporation's fifty percent (50%) or more owned (directly or indirectly) subsidiaries.

8. **Security.** Payment of this Note shall be secured by a pledge of the Purchased Shares with the Corporation pursuant to the Stock Pledge Agreement to be executed this date by the Maker. The Maker, however, shall remain personally liable for payment of this Note, and assets of the Maker, in addition to the collateral under the Stock Pledge Agreement, may be applied to the satisfaction of the Maker's obligations hereunder.

9. **Collection.** If action is instituted to collect this Note, the Maker promises to pay all costs and expenses (including reasonable attorney fees) incurred in connection with such action.

10. **Waiver.** A waiver of any term of this Note, the Stock Pledge Agreement or of any of the obligations secured thereby must be made in writing and signed by a duly-authorized officer of the Corporation and any such waiver shall be limited to its express terms.

No delay by the Corporation in acting with respect to the terms of this Note or the Stock Pledge Agreement shall constitute a waiver of any breach, default, or failure of a condition under this Note, the Stock Pledge Agreement or the obligations secured thereby.

The Maker waives presentment, demand, notice of dishonor, notice of default or delinquency, notice of acceleration, notice of protest and nonpayment, notice of costs, expenses or losses and interest thereon, notice of interest on interest and diligence in taking any action to collect any sums owing under this Note or in proceeding against any of the rights or interests in or to properties securing payment of this Note.

11. **Conflicting Agreements.** In the event of any inconsistencies between the terms of this Note and the terms of any other document related to the loan evidenced by the Note, the terms of this Note shall prevail.

12. **Governing Law.** This Note shall be construed in accordance with the laws of the State of California without resort to that State's conflict-of-laws rules.

/s/ Christos M. Cotsakos

Christos M. Cotsakos, MAKER

E*TRADE GROUP, INC.

STOCK PLEDGE AGREEMENT

AGREEMENT made as of this 19th day of June, 2001 by and between E*TRADE Group, Inc., a Delaware corporation (the "Corporation"), and Christos M. Cotsakos ("Pledgor").

RECITALS

A. In connection with the purchase this day of Two Million Five Hundred Ten Thousand, Three Hundred Twenty-Three (2,510,323) shares of the Corporation's Common Stock (the "Purchased Shares") from the Corporation, Pledgor has issued that certain promissory note (the "Note") dated June 19, 2001 payable to the order of the Corporation in the principal amount of Twelve Million Five Hundred Thousand Dollars (\$12,500,000.00).

B. Such Note is secured by the Purchased Shares and other collateral upon the terms set forth in this Agreement.

NOW, THEREFORE, it is hereby agreed as follows:

1. **Grant of Security Interest.** Pledgor hereby grants the Corporation a security interest in, and assigns, transfers to and pledges with the Corporation, the following securities and other property (collectively, the "Collateral"):

(i) the Purchased Shares delivered to and deposited with the Corporation as collateral for the Note;

(ii) any and all new, additional or different securities or other property subsequently distributed with respect to the Purchased Shares which are to be delivered to and deposited with the Corporation pursuant to the requirements of Paragraph 3 of this Agreement;

(iii) any and all other property and money which is delivered to or comes into the possession of the Corporation pursuant to the terms of this Agreement; and

(iv) the proceeds of any sale, exchange or disposition of the property and securities described in subparagraphs (i), (ii) or (iii) above.

2. **Warranties.** Pledgor hereby warrants that Pledgor is the owner of the Collateral and has the right to pledge the Collateral and that the Collateral is free from all liens, adverse claims and other security interests (other than those created hereby).

3. **Duty to Deliver.** Any new, additional or different securities or other property (other than regular cash dividends) which may now or hereafter become distributable with respect to the Collateral by reason of (i) any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the Common Stock as a class without the Corporation's receipt of consideration or (ii) any merger, consolidation or other reorganization affecting the capital structure of the Corporation shall, upon receipt by Pledgor, be promptly delivered to and deposited with the Corporation as part of the Collateral hereunder. Any such securities shall be accompanied by one or more properly-endorsed stock power assignments.

4. **Payment of Taxes and Other Charges.** Pledgor shall pay, prior to the delinquency date, all taxes, liens, assessments and other charges against the Collateral, and in the event of Pledgor's failure to do so, the Corporation may at its election pay any or all of such taxes and other charges without contesting the validity or legality thereof. The payments so made shall become part of the indebtedness secured hereunder and until paid shall bear interest at the minimum per annum rate, compounded semi-annually, required to avoid the imputation of interest income to the Corporation and compensation income to Pledgor under the Federal tax laws.

5. **Stockholder Rights.** So long as there exists no event of default under Paragraph 10 of this Agreement, Pledgor may exercise all stockholder voting rights and be entitled to receive any and all regular cash dividends paid on the Collateral and all proxy statements and other stockholder materials pertaining to the Collateral.

6. **Rights and Powers of Corporation.** The Corporation may, without obligation to do so, exercise at any time and from time to time one or more of the following rights and powers with respect to any or all of the Collateral:

(i) subject to the applicable limitations of Paragraph 9, accept in its discretion other property of Pledgor in exchange for all or part of the Collateral and release Collateral to Pledgor to the extent necessary to effect such exchange, and in such event the other property received in the exchange shall become part of the Collateral hereunder;

(ii) perform such acts as are necessary to preserve and protect the Collateral and the rights, powers and remedies granted

with respect to such Collateral by this Agreement; and

(iii) transfer record ownership of the Collateral to the Corporation or its nominee and receive, endorse and give receipt for, or collect by legal proceedings or otherwise, dividends or other distributions made or paid with respect to the Collateral, provided and only if there exists at the time an outstanding event of default under Paragraph 10 of this Agreement. Any cash sums which the Corporation may so receive shall be applied to the payment of the Note and any other indebtedness secured hereunder, in such order of application as the Corporation deems appropriate. Any remaining cash shall be paid over to Pledgor.

Any action by the Corporation pursuant to the provisions of this Paragraph 6 may be taken without notice to Pledgor. Expenses reasonably incurred in connection with such action shall be payable by Pledgor and form part of the indebtedness secured hereunder as provided in Paragraph 12.

7. Care of Collateral. The Corporation shall exercise reasonable care in the custody and preservation of the Collateral. However, the Corporation shall have no obligation to (i) initiate any action with respect to, or otherwise inform Pledgor of, any conversion, call, exchange right, preemptive right, subscription right, purchase offer or other right or privilege relating to or affecting the Collateral, (ii) preserve the rights of Pledgor against adverse claims or protect the Collateral against the possibility of a decline in market value or (iii) take any action with respect to the Collateral requested by Pledgor unless the request is made in writing and the Corporation determines that the requested action will not unreasonably jeopardize the value of the Collateral as security for the Note and other indebtedness secured hereunder.

Subject to the limitations of Paragraph 9, the Corporation may at any time release and deliver all or part of the Collateral to Pledgor, and the receipt thereof by Pledgor shall constitute a complete and full acquittance for the Collateral so released and delivered. The Corporation shall accordingly be discharged from any further liability or responsibility for the Collateral, and the released Collateral shall no longer be subject to the provisions of this Agreement.

8. Transfer of Collateral. In connection with the transfer or assignment of the Note (whether by negotiation, discount or otherwise), the Corporation may transfer all or any part of the Collateral, and the transferee shall thereupon succeed to all the rights, powers and remedies granted the Corporation hereunder with respect to the Collateral so transferred. Upon such transfer, the Corporation shall be fully discharged from all liability and responsibility for the transferred Collateral.

9. Release of Collateral. Provided all indebtedness secured hereunder (other than payments not yet due and payable under the Note) shall at the time have been paid in full and there does not otherwise exist any event of default under Paragraph 10, the Purchased Shares, together with any additional Collateral which may hereafter be pledged and deposited hereunder, shall be released from pledge and returned to Pledgor in accordance with the following provisions:

(i) Upon payment or prepayment of principal under the Note, together with payment of all accrued interest to date on the principal amount so paid or prepaid, one or more of the Purchased Shares held as Collateral hereunder shall (subject to the applicable limitations of Paragraphs 9(ii) and 9(v) below) be released at the time of such payment or prepayment. The number of the shares to be so released shall be equal to the number obtained by multiplying (i) the total number of Purchased Shares held under this Agreement at the time of the payment or prepayment, by (ii) a fraction, the numerator of which shall be the amount of the principal paid or prepaid and the denominator of which shall be the unpaid principal balance of the Note immediately prior to such payment or prepayment. In no event, however, shall any fractional shares be released.

(ii) Any additional Collateral which may hereafter be pledged and deposited with the Corporation (pursuant to the requirements of Paragraph 3) with respect to the Purchased Shares shall be released at the same time the particular shares of Common Stock to which the additional Collateral relates are to be released in accordance with the applicable provisions of Paragraph 9(i) or 9(vi).

(iii) Under no circumstances, however, shall any Purchased Shares or any other Collateral be released if previously applied to the payment of any indebtedness secured hereunder. In addition, in no event shall any Purchased Shares or other Collateral be released pursuant to the provisions of Paragraph 9(i), 9(ii) or 9(vi) if, and to the extent, the fair market value of the Common Stock and all other Collateral which would otherwise remain in pledge hereunder after such release were effected would be less than the unpaid principal and accrued interest under the Note.

(iv) For all valuation purposes under this Agreement, the fair market value per share of Common Stock on any relevant date shall be determined in accordance with the following provisions:

(A) If the Common Stock is at the time traded on the Nasdaq National Market, the fair market value shall be the average of the high and low selling prices per share of Common Stock on the date in question, as such prices are reported by the National Association of Securities Dealers on the Nasdaq National Market. If there is no average of the high and low selling prices for the Common Stock on the date in question, then the average of the high and low selling prices on the last preceding date for which such quotation exists shall be determinative of fair market value.

(B) If the Common Stock is at the time listed on the American Stock Exchange or the New York Stock Exchange, then the fair market value shall be the average of the high and low selling prices per share of Common Stock on the date in question on the securities exchange serving as the primary market for the Common Stock, as such prices are officially quoted in the composite tape of transactions on such exchange. If there is no average of the high and low selling prices of Common Stock on such exchange on the date in question, then the fair market value shall be the average of the high and low selling prices on the exchange on the last preceding date for which such quotation exists.

(C) If the Common Stock is at the time neither listed on any securities exchange nor traded on the Nasdaq National Market, the fair market value shall be determined by the Corporation's Board of Directors after taking into Account such factors as the Board shall deem appropriate.

(v) So long as the Collateral is in whole or in part comprised of "margin stock" within the meaning of Section 221.2 of Regulation U of the Federal Reserve Board, then no Collateral shall be substituted for any Collateral under the provisions of Paragraph 6(i) or be released under Paragraph 9(i), 9(ii) or 9(vi), unless there is compliance with each of the following additional requirements:

(A) The substitution or release must not increase the amount by which the indebtedness secured hereunder at the time of such substitution or release exceeds the maximum loan value (as defined below) of the Collateral immediately prior to such substitution or release.

(B) The substitution or release must not cause the amount of indebtedness secured hereunder at the time of such substitution or release to exceed the maximum loan value of the Collateral remaining after such substitution or release is effected.

(C) For purposes of this Paragraph 9(v), the maximum loan value of each item of Collateral shall be determined on the day the substitution or release is to be effected and shall, in the case of the shares of Common Stock and any additional Collateral (other than margin stock), equal the good faith loan value thereof (as defined in Section 221.2 of Regulation U) and shall, in the case of all margin stock (other than the Common Stock), equal fifty percent (50%) of the current market value of such margin stock.

(vi) The Compensation Committee of the Corporation's Board of Directors shall have the discretion, exercisable upon such terms and conditions as the Compensation Committee deems advisable, to authorize the release of one or more shares of Common Stock from pledge hereunder in the event the maximum loan value of the Collateral pledged hereunder (as such value is determined pursuant to subparagraph 9(v)(C)) should substantially exceed the outstanding indebtedness at the time secured hereunder. Any such release of the pledged shares of Common Stock shall, however, be effected in compliance with the requirements of subparagraphs (iii) and (v) of this Paragraph 9.

10. **Events of Default.** The occurrence of one or more of the following events shall constitute an event of default under this Agreement:

- (i) the failure of Pledgor to pay, when due under the Note, any installment of principal or accrued interest; or
- (ii) the occurrence of any other acceleration event specified in the Note; or
- (iii) the failure of Pledgor to perform any obligation imposed upon Pledgor by reason of this Agreement; or
- (iv) the breach of any warranty of Pledgor contained in this Agreement.

Upon the occurrence of any such event of default, the Corporation may, at its election, declare the Note and all other indebtedness secured hereunder to become immediately due and payable and may exercise any or all of the rights and remedies granted to a secured party under the provisions of the California Uniform Commercial Code (as now or hereafter in effect), including (without limitation) the power to dispose of the Collateral by public or private sale or to accept the Collateral in full payment of the Note and all other indebtedness secured hereunder.

Any proceeds realized from the disposition of the Collateral pursuant to the foregoing power of sale shall be applied first to the payment of expenses incurred by the Corporation in connection with the disposition, then to the payment of the Note and finally to any other indebtedness secured hereunder. Any surplus proceeds shall be paid over to Pledgor. However, in the event such proceeds prove insufficient to satisfy all obligations of Pledgor under the Note, then Pledgor shall remain personally liable for the resulting deficiency.

11. **Other Remedies.** The rights, powers and remedies granted to the Corporation pursuant to the provisions of this Agreement shall be in addition to all rights, powers and remedies granted to the Corporation under any statute or rule of law. Any forbearance, failure or delay by the Corporation in exercising any right, power or remedy under this Agreement shall not be deemed to be a waiver of such right, power or remedy. Any single or partial exercise of any right, power or remedy under this Agreement shall not preclude the further exercise thereof, and every right, power and remedy of the Corporation under this Agreement shall continue in full force and effect unless such right, power or remedy is specifically waived by an instrument executed by the Corporation.

12. **Costs and Expenses.** All costs and expenses (including reasonable attorneys fees) incurred by the Corporation in the exercise or enforcement of any right, power or remedy granted it under this Agreement shall become part of the indebtedness secured hereunder and shall constitute a personal liability of Pledgor payable immediately upon demand and bearing interest until paid at the minimum per annum rate, compounded semiannually, required to avoid the imputation of interest income to the Corporation and compensation income to Pledgor under the Federal tax laws.

13. **Applicable Law.** This Agreement shall be governed by and construed in accordance with the laws of the State of California without resort to that State's conflict-of-laws rules.

14. **Successors.** This Agreement shall be binding upon the Corporation and its successors and assigns and upon Pledgor and the executors, heirs and legatees of Pledgor's estate.

15. **Severability.** If any provision of this Agreement is held to be invalid under applicable law, then such provision shall be ineffective only to the extent of such invalidity, and neither the remainder of such provision nor any other provisions of this Agreement shall be affected thereby.

IN WITNESS WHEREOF, this Agreement has been executed by Pledgor and the Corporation on this 19th day of June, 2001.

/s/ CHRISTOS M. COTSAKOS

PLEDGOR

Address:

AGREED TO AND ACCEPTED BY:

E*TRADE GROUP, INC.

By: /s/ RUSSELL S. ELMER

Title: Chief People and Culture Officer

Dated: June 19, 2001

ASSIGNMENT SEPARATE FROM CERTIFICATE

FOR VALUE RECEIVED, _____ hereby sells, assigns and transfers unto E*TRADE Group, Inc. (the "Corporation"), _____ (____) shares of the Common Stock of the Corporation standing in his name on the books of the Corporation represented by Certificate No. ____ herewith and does hereby irrevocably constitute and appoint _____ Attorney to transfer the said stock on the books of the Corporation with full power of substitution in the premises.

Dated:

Signature:

Instruction: Please do not fill in any blanks other than the signature line. Please sign exactly as you would like your name to appear on the issued stock certificate.