FORM 10-Q

E TRADE FINANCIAL CORP - ETFC

Filed: May 15, 2002 (period: March 31, 2002)

Quarterly report with a continuing view of a company's financial position

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**

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

For the quarterly period ended March 31, 2002

Commission file number 1-11921

E*TRADE Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**94-2844166**
(State or other jurisdiction of incorporation or organization)	**(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 May 3, 2002, there were 355,290,580 shares of common stock and 1,670,961 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 March 31, 2002

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The page numbers in this Table of Contents reflect actual page numbers, not EDGAR page tag numbers.

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 March 31, 2002	Three Months Ended March 31, 2001
Revenues:		
Brokerage revenues:		
Commissions	$ 82,527	$ 115,825
Principal transactions	55,315	31,172
Other brokerage-related services	36,761	48,960
Interest income	53,051	100,745
Interest expense	(3,893)	(38,735)
Net brokerage revenues	223,761	257,967
Banking revenues:		
Gain on sales of originated loans	24,675	9,184
Gain on sale of loans held-for-sale and securities—net	21,622	19,110
Other banking-related revenues	10,384	8,444
Interest income	202,668	216,685
Interest expense	(148,851)	(180,366)
Provision for loan losses	(3,382)	(1,443)
Net banking revenues	107,116	71,614
Total net revenues	330,877	329,581
Cost of services	140,752	142,435
Operating expenses:		
Selling and marketing	68,964	93,698
Technology development	14,504	22,281
General and administrative	54,029	60,242
Amortization of goodwill and other intangibles	6,724	7,999
Acquisition-related expenses	1,260	—
Restructuring and other nonrecurring charges	(223)	—
Total operating expenses	145,258	184,220
Total cost of services and operating expenses	286,010	326,655
Operating income	44,867	2,926
Non-operating income (expense):		
Corporate interest income	3,580	5,778
Corporate interest expense	(12,396)	(11,228)
Gain (loss) on sale of investments	1,693	(2,531)
Equity in income (losses) of investments	284	(3,341)
Unrealized loss on venture funds	(1,781)	(11,611)
Fair value adjustments of financial derivatives	(991)	334
Other	(954)	(700)
Total non-operating expense	(10,565)	(23,299)
Pre-tax income (loss)	34,302	(20,373)
Income tax provision (benefit)	14,751	(13,242)
Minority interest in subsidiaries	193	35
Income (loss) before extraordinary gain (loss) and cumulative effect of accounting change	19,358	(7,166)
Extraordinary gain (loss) on early extinguishment of debt, net of tax	4,074	(2,037)
Cumulative effect of accounting change	(299,413)	—
Net loss	$ (275,981)	$ (9,203)
Income (loss) per share before extraordinary gain (loss) on early extinguishment of debt and cumulative effect of accounting change:		
Basic	$ 0.06	$ (0.02)
Diluted	$ 0.05	$ (0.02)
Net loss per share:		
Basic	$ (0.80)	$ (0.03)

Diluted	$ (0.80)	$ (0.03)
Shares used in computation of per share data (See Note 9):		
Basic	346,950	317,242
Diluted	356,958	317,242

See notes to condensed consolidated financial statements.

E*TRADE GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	March 31, 2002 (unaudited)	December 31, 2001
ASSETS		
Cash and equivalents	$ 1,085,095	$ 836,201
Cash and investments required to be segregated under Federal or other regulations	788,566	764,729
Brokerage receivables—net	2,120,687	2,139,153
Mortgage-backed securities	4,312,814	3,556,619
Loans receivable—net of allowance for loan losses of $16,699 at March 31, 2002 and $19,874 at December 31, 2001	6,171,186	6,394,368
Loans held-for-sale	863,898	1,616,089
Investments	1,150,669	1,168,623
Property and equipment—net	410,229	331,724
Goodwill	261,382	559,918
Other intangible assets	130,899	124,508
Other assets	714,465	680,482
Total assets	$ 18,009,890	$ 18,172,414
LIABILITIES AND SHAREOWNERS' EQUITY		
Liabilities:		
Brokerage payables	$ 2,627,657	$ 2,699,984
Banking deposits	8,986,184	8,082,859
Borrowings by bank subsidiary	3,404,175	4,170,440
Convertible subordinated notes	710,330	760,250
Accounts payable, accrued and other liabilities	876,057	818,464
Total liabilities	16,604,403	16,531,997
Company-obligated mandatorily redeemable preferred capital securities of subsidiary trusts holding solely junior subordinated debentures of ETFC (redemption value $72,375)	69,530	69,503
Commitments and contingencies		
Shareowners' equity:		
Preferred stock, shares authorized: 1,000,000; issued and outstanding: none at March 31, 2002 and December 31, 2001	—	—
Shares exchangeable into common stock, $.01 par value, shares authorized: 10,644,223; issued and outstanding: 1,670,961 at March 31, 2002 and 1,825,632 at December 31, 2001	17	18
Common stock, $.01 par value, shares authorized: 600,000,000; issued and outstanding: 353,832,937 at March 31, 2002 and 347,592,480 at December 31, 2001	3,538	3,476
Additional paid-in capital	2,124,253	2,072,701
Shareowners' notes receivable	(31,862)	(32,707)
Deferred stock compensation	(25,209)	(28,110)
Accumulated deficit	(523,068)	(247,087)
Accumulated other comprehensive loss	(211,712)	(197,377)
Total shareowners' equity	1,335,957	1,570,914
Total liabilities and shareowners' equity	$ 18,009,890	$ 18,172,414

See notes to condensed consolidated financial statements.

E*TRADE GROUP, INC. AND SUBSIDIARIES

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

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
Net cash provided by (used in) operating activities	$ 579,359	$ (92,546)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of mortgage-backed securities, available-for-sale securities and other investments	(2,226,808)	(2,800,789)
Proceeds from sales, maturities of and principal payments on mortgage-backed securities, available-for-sale securities and other investments	1,535,260	3,335,754
Net decrease (increase) in loans receivable	223,138	(928,813)
Decrease in restricted deposits	71,888	45
Purchases of property and equipment, net of property and equipment received in business acquisitions	(16,514)	(62,715)
Investing derivative activity	(37,483)	—
Other	2,368	1,460
Net cash used in investing activities	(448,151)	(455,058)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in banking deposits	903,324	1,112,421
Advances from the Federal Home Loan Bank	1,263,055	1,489,000
Payments on advances from the Federal Home Loan Bank	(1,313,055)	(2,039,000)
Net decrease in securities sold under agreements to repurchase	(372,528)	(45,927)
Net decrease in other borrowed funds	(343,747)	—
Repayments on loans to related parties, net of loans issued	887	2,899
Proceeds from issuance of common stock from associate stock transactions	6,353	10,806
Proceeds from bank loans and lines of credit, net of transaction costs	—	2,172
Payments on bank loans and lines of credit	(1,986)	(23,626)
Repayment of capital lease obligations	(3,097)	(3,182)
Financing derivative activity	(20,509)	—
Other	(1,011)	34
Net cash provided by financing activities	117,686	505,597
INCREASE (DECREASE) IN CASH AND EQUIVALENTS	248,894	(42,007)
CASH AND EQUIVALENTS—Beginning of period	836,201	456,878
CASH AND EQUIVALENTS—End of period	$ 1,085,095	$ 414,871
SUPPLEMENTAL DISCLOSURES:		
Selected adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	$ 36,620	$ 41,577
Amortization (accretion) of premium (discount) of investment securities	$ 13,455	$ (5,504)
Non-cash investing and financing activities:		
Purchase of technology operations center	$ 71,888	$ —
Tax benefit on exercise of stock options	$ 2,135	$ 3,029
Transfer from loans to other real estate owned and repossessed assets	$ 8,151	$ 480
Assets acquired under capital lease obligations	$ 437	$ 1,339
Deferred stock compensation	$ 2,901	$ 14,510
Purchase acquisitions, net of cash acquired:		
Common stock issued and stock options assumed	$ —	$ 52,008
Cash paid, less acquired (including acquisition costs)	—	1,521
Liabilities assumed	—	10
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 $0 and $38,452)	$ —	$ 42,456

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. ("the Parent"), a financial services holding company, and its subsidiaries, collectively ("the Company" or "E*TRADE"), including but not limited to E*TRADE Securities, Incorporated ("E*TRADE Securities"), a securities broker-dealer, TIR (Holdings) Limited ("E*TRADE Institutional"), a provider of global securities brokerage and other related services to institutional clients, E*TRADE Financial Corporation ("ETFC"), a provider of financial services whose primary business is conducted by E*TRADE Bank ("the Bank") and E*TRADE Global Asset Management, Inc. ("ETGAM"), E*TRADE Technologies, Inc., a Canadian-based provider of electronic securities trading services for institutional and retail investors, Web Street, Inc. ("Web Street"), a provider of online brokerage services and Dempsey and Company, LLC ("Dempsey"), a specialist and market-making firm. The Bank is a federally chartered savings bank that provides deposit accounts insured by the Federal Deposit Insurance Corporation ("FDIC") to customers nationwide. E*TRADE Access, Inc. ("E*TRADE Access"), an independent network of centrally-managed automated teller machines ("ATMs") in the United States and Canada and E*TRADE Mortgage Corporation ("E*TRADE Mortgage"), an Internet-based mortgage loan originator, are subsidiaries of the Bank. ETGAM is a funds manager and registered broker-dealer.

In September 2000, the Company entered into a joint venture with Ernst & Young LLP ("E&Y") to form Enlight Holdings LLC ("Enlight Holdings"), which in turn owns eAdvisor, to develop an online personalized financial advice and planning tool for individuals. As of December 31, 2001, the Company owned 49% of Enlight Holdings. In February 2002, the Company determined that as a result of additional contributions and changes in the number of board of director seats, the Company has the ability to control the operations of Enlight Holdings and therefore the Company has consolidated its financial position and results of operations into the Company's consolidated financial statements. Prior to consolidation, the Company recorded losses from equity investments related to eAdvisor of $(52,000) for the three months ended March 31, 2002 and $(1.6) million for the three months ended March 31, 2001.

Beginning in January 2002, the Company changed its presentation of revenue from that previously presented; however, no changes to its accounting policies or methods were made. Under the new format, net brokerage revenues consist of commissions, principal transactions, other brokerage-related, interest income and interest expense. Commissions include domestic and international transaction revenues. Previously, international transactions were included under the caption "global and institutional." Principal transactions include revenues from institutional activities, previously included in global and institutional, and market-making activities, previously included in other revenues. Other brokerage-related revenues include account maintenance fees, payments from order flow, Business Solutions Group revenue and mutual fund revenue. Except for order flow, which was previously included in transaction revenues, other brokerage-related items were included in other revenues. Net banking revenues consist of gain on sale of originated loans, gain on sale of loans held-for-sale and securities-net, other banking-related, interest income, interest expense and provision for loan losses. Other banking-related revenues are primarily comprised of automated teller machine revenues.

On July 30, 1999, the Company entered into a lease agreement for its 164,500 square foot technology operation center located near Atlanta, Georgia. To secure the lease, the Company posted cash collateral, which was $71.9 million at December 31, 2001. On March 27, 2002, the Company exercised its purchase option and used the cash collateral to fund the purchase on April 29, 2002. As a result, the Company has included the property and related payable for the purchase of $71.9 million on its Consolidated Balance Sheet. The cash collateral is included in cash and equivalents as of March 31, 2002.

These unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("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 December 31, 2001.

In April 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 145, *Rescission of FASB Statement No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.* SFAS 145 requires that any gains or losses on extinguishment of debt that were classified as an extraordinary item in prior periods that are not unusual in nature and infrequent in occurrence be reclassified to other income (expense), beginning in fiscal 2003, with early adoption encouraged. The Company is currently evaluating when to adopt the requirements of SFAS No. 145 in its consolidated financial statements.

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

NOTE 2. GOODWILL AND INTANGIBLE ASSETS

On January 1, 2002, the Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets*, which requires that all intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives not be amortized, but rather tested upon adoption and at least annually for impairment. In accordance with SFAS No. 142, the Company discontinued the amortization of its recorded goodwill as of that date, identified its reporting units based on its current segment reporting structure and allocated all recorded goodwill, as well as other assets and liabilities, to the reporting units. The Company determined the fair value of its reporting units utilizing discounted cash flow models and relative market multiples for comparable businesses. The Company compared the fair value of each of its reporting units to its carrying value. This evaluation indicated that goodwill associated with its reporting units in the Global and Institutional and its Wealth Management segments were impaired. This impairment is primarily attributable to the change in the evaluation criteria for goodwill from an undiscounted cash flow approach, which was previously utilized under the guidance in Accounting Principle Board Opinion No. 17, to the fair value approach, which is stipulated in SFAS No. 142. A non-cash charge totaling $299.4 million has been recorded as a change in accounting principle effective January 1, 2002 to write-off goodwill of $292.6 million in the Global and Institutional segment and $6.8 million in the Wealth Management segment. Remaining recorded goodwill following this impairment write down, by segment, as of March 31, 2002 was (in thousands):

Domestic Retail Brokerage and Other	$	147,336
Banking		114,046
Total	$	261,382

Other intangible assets, which will continue to be amortized, consist of the following:

(in thousands)	Weighted Average Useful Life(1) (years)	As of March 31, 2002 Gross Amount	Accumulated Amortization	Net Amount	As of December 31, 2001 Gross Amount	Accumulated Amortization	Net Amount
Specialist books	30	$ 59,800	$ 997	$ 58,803	$ 59,800	$ 506	$ 59,294
Active accounts(2)	7	53,830	11,366	42,464	52,599	7,514	45,085
Access contracts	5	24,231	8,654	15,577	24,231	7,391	16,840
Deposit intangibles	3	14,634	1,211	13,423	3,165	549	2,616
Other	5	824	192	632	824	151	673
Total		$153,319	$ 22,420	$130,899	$140,619	$ 16,111	$124,508

(1) The Company evaluated the useful lives of its other intangible assets and determined that they should continue to be amortized based on the original useful lives assigned.
(2) Amortized using an accelerated method.

Amortization expense of other intangible assets was $6.7 million for the three months ended March 31, 2002 and $1.3 million for the three months ended March 31, 2001. Assuming no future impairments of these assets or additions as the result of acquisitions, annual amortization expense will be $24.8 million in fiscal 2002, $21.5 million in fiscal 2003, $17.9 million in fiscal 2004, $9.3 million in fiscal 2005 and $6.9 million in fiscal 2006.

A reconciliation of previously reported net income and earnings per share to the amounts adjusted for the exclusion of goodwill amortization is provided below (in thousands except per share amounts):

	Three Months Ended March 31, 2002			2001		
		Per Share			Per Share	
	Amount	Basic	Diluted	Amount	Basic	Diluted
Reported income (loss) before extraordinary items and cumulative effect of accounting change	$ 19,358	$ 0.06	$ 0.05	$ (7,166)	$ (0.02)	$ (0.02)
Add: Goodwill amortization	—	—	—	6,709	0.02	0.02
Adjusted income (loss) before extraordinary items	19,358	0.06	0.05	(457)	(0.00)	(0.00)
Extraordinary items	4,074	0.01	0.01	(2,037)	(0.01)	(0.01)
Adjusted net income (loss)	$ 23,432	$ 0.07	$ 0.06	$ (2,494)	$ (0.01)	$ (0.01)

NOTE 3. FACILITY RESTRUCTURING CHARGES

On August 29, 2001, the Company announced a restructuring plan aimed at streamlining operations primarily by consolidating facilities in the United States and Europe. This restructuring resulted in a pre-tax charge of $202.8 million ($148.0 million after tax) in fiscal 2001. The restructuring was designed to consolidate certain facilities to bring together key decision-makers and streamline operations.

The Company recorded a pre-tax restructuring charge of $128.5 million related to its facilities consolidation in 2001, representing the undiscounted value of ongoing lease commitments offset by anticipated third party subleases. The charge also includes a pre-tax write-off of leasehold improvements and furniture and fixtures totaling $38.6 million. The charge did not include relocation costs that will be incurred over the next 12 months and expensed as incurred. The cash outflow related to this action will be paid out over the length of committed lease terms of 7 to 11 years. In the three months ended March 31, 2002, the Company reduced its facilities charge by $2.0 million as management has determined that it will use more facility space than originally estimated in the restructuring plan.

The Company also recorded a pre-tax restructuring charge of $52.5 million related to the write-off of capitalized software and hardware related to the aforementioned technology projects and other fixed assets. In calculating the charge related to its asset write-off, the Company calculated the amount of the write-offs as the net book value of assets less the amount of estimated proceeds upon disposition for certain saleable assets, including real estate properties owned. In the three months ended March 31, 2002, a related party, though not obligated, reimbursed the Company for the value of the impairment of one of these properties, which was recorded in our initial restructuring charge. The reimbursement of approximately $0.7 million was offset by an additional increase in the restructuring accrual resulting from the identification of additional excess equipment of approximately $0.2 million.

The restructuring accrual also included other pre-tax charges of $21.8 million in 2001 for committed expenses, termination of consulting agreements, severance and cancellation penalties on various services that will no longer be required in the facilities the Company is vacating. The Company increased the restructuring charge included in Other by $2.3 million in the three months ended March 31, 2002 primarily for additional severance payments made to additional associates identified during the first quarter. Severance is recorded in the period in which associates are identified and communication is made to these individuals.

A summary of the facility restructuring charges is outlined as follows:

	Facility Consolidation	Asset Write-Off	Other	Total
		(in thousands)		
Facility restructuring charges recorded in fiscal 2001	$ 128,469	$ 52,532	$21,764	$202,765
Activity for fiscal 2001:				
Cash charges	(7,534)	(49)	(8,846)	(16,429)
Non-cash charges	(38,570)	(52,483)	(5,740)	(96,793)
Restructuring liabilities at December 31, 2001	82,365	—	7,178	89,543
Activity for the three months ended March 31, 2002:				
Adjustments and additional charges	(2,026)	(453)	2,256	(223)
Cash charges	(3,818)	—	(4,390)	(8,208)
Non-cash charges	(1,496)	453	—	(1,043)
Restructuring liabilities at March 31, 2002	$ 75,025	$ —	$ 5,044	$ 80,069

NOTE 4. BUSINESS COMBINATIONS

In October 2001, the Company acquired Dempsey, a privately-held specialist and market-making firm, for an aggregate purchase price of $173.4 million, comprised of approximately 28.9 million shares of the Company’s common stock valued at $153.4 million and an additional $20.0 million in cash. The acquisition was accounted for using the purchase method of accounting and the results of Dempsey’s operations have been combined with those of the Company since the date of acquisition. The Company paid an additional amount of approximately $1.3 million, which represents management continuity payments associated with its acquisition of Dempsey. These charges were recorded as acquisition-related costs for the three months ended March 31, 2002.

In June 2001, the Company acquired Web Street, an online brokerage firm, for an aggregate purchase price of $48.5 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 $0.7 million and acquisition costs of approximately $4.3 million. The acquisition was accounted for using the purchase method of accounting and the results of Web Street’s operations have been combined with those of the Company from the date of acquisition. In the three months ended March 31, 2002, the Company paid an additional $1.2 million for certain contingencies that existed at the date of acquisition. As a result, the Company recorded an additional amount to the purchase price for $1.2 million.

In February 2001, the Company acquired E*TRADE Mortgage, formerly LoansDirect, Inc., an online 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. 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 proforma information below assumes that the acquisitions of Dempsey, Web Street and E*TRADE Mortgage occurred at the beginning of fiscal 2001 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):

	Three Months Ended March 31, 2001
Net revenues	$ 374,555
Loss before extraordinary gain on early extinguishment of debt and settlement of litigation, net of tax	$ (10,574)
Net loss	$ (12,611)
Basic and diluted loss per share before extraordinary gain on early extinguishment of debt	$ (0.03)
Basic and diluted loss per share	$ (0.04)

The proforma information is for information purposes only and is not necessarily indicative of the results of future operations or results that would have been achieved had the acquisition taken place at the beginning of fiscal 2001.

NOTE 5. BROKERAGE RECEIVABLES—NET AND PAYABLES

Brokerage receivables—net and payables consist of the following:

	March 31, 2002	December 31, 2001
	(in thousands)	
Receivable from customers and non-customers (less allowance for doubtful accounts of $3,161 at March 31, 2002 and $3,608 at December 31, 2001)	$ 1,762,180	$ 1,631,845
Receivable from brokers, dealers and clearing organizations:		
Net settlement and deposits with clearing organizations	104,000	113,527
Deposits paid for securities borrowed	245,867	371,682
Securities failed to deliver	887	776
Other	7,753	21,323
Total brokerage receivables—net	$ 2,120,687	$ 2,139,153
Payable to customers and non-customers	$ 2,166,464	$ 2,018,352
Payable to brokers, dealers and clearing organizations:		
Deposits received for securities loaned	421,512	648,168
Securities failed to receive	1,613	1,491
Other	38,068	31,973
Total brokerage payables	$ 2,627,657	$ 2,699,984

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. Credit extended to customers and non-customers with respect to margin accounts was $1,582 million at March 31, 2002 and $1,537 million at

December 31, 2001. 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 March 31, 2002, the Company has received collateral primarily in connection with securities borrowed and customer margin loans with a market value of $1,752 million, which it can sell or repledge. Of this amount, $601 million has been pledged or sold as of March 31, 2002 in connection with securities loans, bank borrowings and deposits with clearing organizations. Included in deposits paid for securities borrowed and deposits received for securities loaned at March 31, 2002 are amounts from transactions involving MJK Clearing and three other brokers. The parties in this transaction have a dispute over the amounts owed, as more fully described in Note 12 "Commitments, Contingencies and Other Regulatory Matters." 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 6. INVESTMENTS

Investments are comprised of trading and available-for-sale debt and equity securities, as defined under the provisions of SFAS 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 has the ability to exercise significant influence, which are accounted for under the equity method, as well as some investments accounted for under the cost method.

The carrying amounts of investments are shown below:

	March 31, 2002	December 31, 2001
	(in thousands)	
Trading securities	$ 177,754	$ 87,392
Available-for-sale investment securities	898,907	998,487
Equity method and other investments:		
Joint ventures	21,460	28,664
Venture capital funds	15,959	17,553
Other investments	36,589	36,527
Total investments	$ 1,150,669	$ 1,168,623

Included in available-for-sale securities are investments in several companies that are publicly-traded and carried at fair value. Unrealized gains related to these investments were $2.9 million at March 31, 2002 and $6.9 million at December 31, 2001. Unrealized losses related to these investments were $28.3 million at March 31, 2002 and $19.9 million at December 31, 2001.

NOTE 7. LINE OF CREDIT AND OTHER BORROWINGS

The Company has one installment purchase contract and term loans from financial institutions which are collateralized by equipment owned by the Company. Borrowings under these term loans bear interest at 3.00% to 3.25% above LIBOR (4.88% to 5.13% at March 31, 2002). The Company had approximately $12.8 million outstanding under these loans at March 31, 2002, which is included in accounts payable, accrued and other liabilities.

In November 2001, the Company renewed a $50 million line of credit under an agreement with a bank that expires in October 2002. 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 (2.23% at March 31, 2002). The Company had no borrowings outstanding under this line of credit at March 31, 2002.

NOTE 8. COMPREHENSIVE LOSS

The reconciliation of net loss to comprehensive loss is as follows:

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
	(in thousands)	
Net loss	$ (275,981)	$ (9,203)
Changes in other comprehensive loss:		
Unrealized loss on available-for-sale securities, net of tax	(18,937)	(51,618)
Reclassification as a result of realized (gains) losses on available-for-sale securities, net of tax	(10,976)	24,171
Unrealized gain (loss) on derivative instruments, net of tax, and reclassification adjustment	15,561	(50,050)
Amortization of de-designated hedges and transition adjustments, net of tax	263	502
Cumulative translation adjustments	(246)	(4,298)
Total comprehensive loss	$ (290,316)	$ (90,496)

NOTE 9. NET LOSS PER SHARE

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

	Three Months Ended March 31, 2002		2001
	Basic	Diluted	Basic and Diluted
	(in thousands)		
Numerator:			
Income (loss) before extraordinary gain (loss) on early extinguishment of debt and cumulative effect of accounting change	$ 19,358	$ 19,358	$ (7,166)
Extraordinary gain (loss) on early extinguishment of debt, net of tax	4,074	4,074	(2,037)
Cumulative effect of accounting change	(299,413)	(299,413)	—
Net loss	$(275,981)	$(275,981)	$ (9,203)
Denominator:			
Weighted average shares outstanding	346,950	346,950	317,242
Diluted effect of options and restricted stock awards outstanding	—	9,661	—
Diluted effect of warrants and contingent shares outstanding	—	347	—
	346,950	356,958	317,242

Because the Company reported a loss before extraordinary loss on the early extinguishment of debt and a net loss for the three months ended March 31, 2001, and a net loss for the three months ended March 31, 2002, the calculation of diluted loss per share does not include common stock equivalents as they are anti-dilutive and would result in a reduction of loss per share. If the Company had reported income before the extraordinary loss on the early extinguishment of debt and net income for the three months ended March 31, 2001, there would have been 10,294,000 additional shares for options outstanding and 198,000 additional shares for warrants outstanding. If the Company had reported net income for the three months ended March 31, 2002, there would have been 9,661,000 additional shares for options and restricted stock awards outstanding and 347,000 additional shares for warrants and contingent shares outstanding. Excluded from the calculations of diluted loss per share and diluted net loss per share for the three months ended March 31, 2002 and 2001 are approximately 47,451,000 and 27,542,000, respectively, 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.

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

	Three Months Ended March 31,	
	2002	2001
Options excluded from computation of diluted net loss per share	17,300	18,784
Exercise price ranges:		
High	$ 58.19	$ 58.19
Low	$ 10.02	$ 10.53

NOTE 10. EXTRAORDINARY GAIN (LOSS) ON EARLY EXTINGUISHMENT OF DEBT

Extraordinary gain (loss) on early extinguishment of debt was $4.1 million in the three months ended March 31, 2002 and $(2.0) million for the three months ended March 31, 2001. In the three months ended March 31, 2002, the Company recorded an extraordinary gain on early extinguishment of debt of $4.1 million (net of tax expense of $2.7 million) from the retirement of $50 million of its 6% convertible subordinated notes in exchange for approximately 4.7 million shares of its common stock. In the three months ended March 31, 2001, the Company recorded an extraordinary loss on early extinguishment of debt of $2.0 million (net of tax benefit of $1.2 million) from the early redemption of $400 million of adjustable and fixed rate advances with the FHLB. The FHLB advances were entered into as a result of normal funding requirements of the Company's banking operations.

NOTE 11. REGULATORY REQUIREMENTS

E*TRADE Securities is subject to the Uniform Net Capital Rule (the "Rule") under the Securities Exchange Act of 1934 administered by the SEC and the National Association of Securities Dealers Regulation, Inc. ("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:

	March 31, 2002	December 31, 2001
	(dollars in thousands)	
Net capital	$ 145,307	$ 240,141
Percentage of aggregate debit balances	8.0%	14.0%
Required net capital	$ 35,419	$ 34,208
Excess net capital	$ 109,888	$ 205,933

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 minimum excess capital requirements for the Company's other U.S. broker-dealer subsidiaries:

	March 31, 2002			December 31, 2001		
(in thousands)	Required Net Capital	Net Capital	Excess Net Capital	Required Net Capital	Net Capital	Excess Net Capital
E*TRADE Institutional Securities, Inc.	$ 309	$ 8,426	$ 8,117	$ 250	$6,407	$ 6,157
E*TRADE Marquette Securities, Inc.	$ 250	$ 521	$ 271	$ 250	$ 532	$ 282
E*TRADE Global Asset Management, Inc.	$ 342	$20,529	$ 20,187	$ 282	$8,999	$ 8,717
E*TRADE Canada Securities Corporation	$ 100	$ 241	$ 141	$ 100	$ 283	$ 183
GVR, LLC	$ 1,000	$ 3,727	$ 2,727	$ 1,000	$4,100	$ 3,100
Web Street Securities and subsidiary	$ 250	$ 941	$ 691	$ 250	$ 796	$ 546
Dempsey	$ 486	$14,899	$ 14,413	$ 802	$8,787	$ 7,985

The Company's broker-dealer subsidiaries, located in Canada, Europe and South East Asia, have various and differing capital requirements, all of which were met at March 31, 2002 and December 31, 2001. The aggregate net capital, required net capital and excess net capital of these companies at March 31, 2002, was $73.9 million, $28.5 million and $45.4 million, respectively. The aggregate net capital, required net capital, and excess net capital of these companies at December 31, 2001, was $69.7 million, $29.7 million and $40.0 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, Core Capital to adjusted tangible assets and Tangible Capital to tangible assets. Management believes that, as of March 31, 2002 the Bank has met all capital adequacy requirements to which it was subject. As of March 31, 2002 and December 31, 2001, the Office of Thrift Supervision ("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 and Tier I Capital to risk-weighted assets and Core Capital to adjusted tangible assets 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. Events beyond management's control, such as fluctuations in interest rates or a downturn in the economy in areas in which the Bank's loans or securities are concentrated, could adversely affect future earnings and consequently, the Bank's ability to meet its future capital requirements.

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

	Actual		Required for Capital Adequacy Purposes		Required to be Well Capitalized Under Prompt Corrective Action Provisions	
(dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of March 31, 2002:						
Total Capital to risk-weighted assets	$869,387	12.51%	>$555,947	>8.0%	>$694,933	>10.0%
Tier I Capital to risk-weighted assets	$852,808	12.27%	N/A	N/A	>$416,960	>6.0%
Core Capital to adjusted tangible assets	$852,808	6.27%	>$543,698	>4.0%	>$679,622	>5.0%
Tangible Capital to tangible assets	$852,808	6.27%	>$203,887	>1.5%	N/A	N/A
As of December 31, 2001:						
Total Capital to risk-weighted assets	$836,866	11.52%	>$580,986	>8.0%	>$726,233	>10.0%
Tier I Capital to risk-weighted assets	$819,367	11.28%	N/A	N/A	>$435,740	>6.0%
Core Capital to adjusted tangible assets	$819,367	6.07%	>$539,671	>4.0%	>$674,588	>5.0%
Tangible Capital to tangible assets	$819,367	6.07%	>$202,377	>1.5%	N/A	N/A

NOTE 12. COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS

In the ordinary course of its business, E*TRADE Securities engaged in certain stock loan transactions with MJK Clearing, Inc. ("MJK"), involving the lending of Nasdaq-listed common stock of GenesisIntermedia, Inc. ("GENI") and other securities from MJK to E*TRADE Securities. Subsequently, E*TRADE Securities redelivered the GENI and/or other securities received from MJK to three other broker-dealers: Wedbush Morgan Securities ("Wedbush"), Nomura Securities, Inc. ("Nomura") and Fiserv Securities, Inc. ("Fiserv"). On September 25, 2001, Nasdaq halted trading in the stock of GENI, which had last traded at a price of $5.90 before the halt. As a result, MJK was unable to meet its collateral requirements on the GENI and other securities with certain counterparties to those transactions. MJK was ordered to cease operations by the SEC because it failed to meet regulatory capital requirements, and was placed into SIPC liquidation in the District of Minnesota. These events have led to disputes among several of the participants in the stock loan transactions involving the stock of GENI and other securities lent by MJK regarding which entities should bear the losses resulting from MJK's insolvency.

Wedbush, Nomura and Fiserv have commenced separate legal actions against E*TRADE Securities. These actions seek various forms of equitable relief and seek repayment of a total of approximately $60.0 million received by E*TRADE Securities in connection with the GENI and other stock loan transactions. Such amounts are included in deposits paid for securities borrowed and deposits received for securities loaned at March 31, 2002 in the accompanying Consolidated Balance Sheets. E*TRADE Securities believes that the plaintiffs must look to MJK as the debtor for repayment, and that it has defenses in each of these actions and will vigorously defend itself in all matters. To date, E*TRADE Securities has successfully defeated all actions for interim relief or has entered into consent orders essentially maintaining the status quo between the parties until the matter can be judicially resolved. E*TRADE Securities is unable to predict the ultimate outcome or the amount of any potential losses.

As of March 31, 2002, the Bank had commitments to purchase $319.4 million in fixed rate and $148.6 million in variable rate loans and commitments to originate $318.4 million in fixed rate and $32.6 million in variable rate loans. In addition, the Bank had $622.9 million in mortgage-backed securities and certificates of deposit approximating $3.4 billion scheduled to mature in less than one year. 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 involving securities, banking and other matters. The Company is also subject to periodic regulatory audits and inspections. Compliance and trading problems that are reported to regulators such as the SEC, the NASDR or the OTS by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal claims being filed against the Company by customers 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 coverage in such amounts and with such coverages, deductibles and policy limits as management believes are reasonable and prudent. The principal insurance coverage it maintains covers comprehensive general liability, commercial property damage, hardware/software damage, directors and officers, certain criminal acts against the Company and errors and omissions. The Company believes that such insurance coverage is adequate for the purpose of its business. Our ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the market place, and world events, including the terrorist attacks of September 11, 2001, may impair the Company’s ability to obtain insurance in the future.

NOTE 13. ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

The Company enters into derivative transactions principally to protect against the risk of market price or interest rate movements on the value of certain assets and future cash flows. The Company is also required to recognize certain contracts and commitments as derivatives when the characteristics of those contracts and commitments meet the definition of a derivative as promulgated by SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS No. 133”).

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 derivative is recognized currently in earnings, as is the change in value of the hedged item attributable to the risk being hedged. Accordingly, the net difference or hedge ineffectiveness, if any, is recognized currently in the consolidated statements of operations as fair value adjustments of financial derivatives in other non-operating income (expense). Fair value hedge ineffectiveness resulted in a loss of $1.0 million for the three months ended March 31, 2002 and income of $1.5 million for the three months ended March 31, 2001.

During the three months ended March 31, 2002 and March 31, 2001, certain 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 gain on sale of loans held-for-sale and securities-net, in the consolidated statement of operations, which totaled $8.6 million of gains for the three months ended March 31, 2002 and $3.4 million of losses for the three months ended March 31, 2001. In addition, the Company recognized $4.8 million for the three months ended March 31, 2002 and $0.2 million for the three months ended March 31, 2001, of hedge ineffectiveness expense in fair value adjustments of financial derivatives, related to these derecognized fair value hedges during the fair value hedge accounting period. The following table summarizes information related to our financial derivatives in fair value hedge relationships as of March 31, 2002 (dollars in thousands):

Assets Hedged	Notional Amount	Fair Value	Asset	Liability	Weighted Average Pay Rate	Weighted Average Receive Rate	Weighted Average Strike Rate	Weighted Average Remaining Life (years)
Loans:								
Pay fixed interest rate swaps	$ 968,973	$ (7,813)	$ 3,797	$ (11,610)	5.29%	1.90%	— %	3.90
Purchased interest rate options—caps	3,929,027	79,986	79,986	—	—	—	6.03	3.00
Purchased interest rate options—floors	683,000	2,966	2,966	—	—	—	5.07	3.32
Total Loans	5,581,000	75,139	86,749	(11,610)	5.29	1.90	5.84	3.27
Mortgage-Backed Securities:								
Pay fixed interest rate swaps	545,527	8,017	8,017	—	4.47	1.91	—	4.26
Purchased interest rate options—caps	1,447,973	74,278	74,278	—	—	—	5.91	5.01
Purchased interest rate options—floors	1,107,750	3,689	3,689	—	—	—	4.49	5.18
Total Mortgage-Backed Securities	3,101,250	85,984	85,984	—	4.47	1.91	5.51	5.12
Total Fair Value Hedges	$ 8,682,250	$161,123	$ 172,733	$ (11,610)	5.10%	1.91%	4.99%	3.93

Cash Flow Hedges

The Company also uses interest rate swaps to hedge the variability of future cash flows associated with existing variable rate liabilities and forecasted issuances of liabilities. These cash flow hedge relationships are treated as effective hedges as long as the future issuances of liabilities remain probable and the hedges continue to meet the requirements of SFAS 133. The Company expects to reclassify approximately $57.1 million of net unrealized losses reported in other comprehensive income ("OCI") to the Consolidated Statement of Operations during the next twelve months. The Company expects to hedge the forecasted issuance of liabilities over a maximum term of 7 years.

The Company measures ineffectiveness for these cash flow hedges in accordance with SFAS 133 and reports this amount as fair value adjustments of financial derivatives in the non-operating income (expense) section of its Consolidated Statements of Operations. The Company recognized $2.7 million of income for cash flow hedge ineffectiveness for the three months ended March 31, 2002 and $0 for the three months ended March 31, 2001.

The following table summarizes information related to our financial derivatives in cash flow hedge relationships hedging variable rate liabilities and the forecasted issuances of liabilities, as of March 31, 2002:

(dollars in thousands)	Notional Amount	Fair Value	Asset	Liability	Weighted Average Pay Rate	Weighted Average Receive Rate	Weighted Average Remaining Life (years)
Liabilities hedged							
Time Deposits:							
Pay fixed interest rate swaps	$1,691,000	$ (68,570)	—	$ (68,570)	6.42%	2.84%	2.20
Repurchase Agreements:							
Pay fixed interest rate swaps	1,972,500	(116,635)	—	(116,635)	6.88	1.81	2.78
Federal Home Loan Bank Advances:							
Pay fixed interest rate swaps	503,300	(27,581)	—	(27,581)	7.04	1.89	2.30
Total Cash Flow Hedges	$4,166,800	$(212,786)	—	$(212,786)	6.57%	2.24%	2.49

Mortgage Banking Activities

The Company enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding; these commitments are referred to as Interest Rate Lock Commitments ("IRLCs"). IRLCs on loans that are intended to be sold are considered to be derivatives and are therefore recorded at fair value with changes in fair value recorded in earnings. The net change in the IRLCs and the related hedging instruments resulted in a net gain of $2.7 million for the three months ended March 31, 2002 and $0 for the three months ended March 31, 2001.

NOTE 14. COLLATERALIZED DEBT OBLIGATION

In September 2001, the Company entered into a Warehousing Agreement with a financial advisor for the purpose of acquiring a portfolio of investment grade asset-backed securities ("Collateral"). The Company intends to transfer this Collateral into one or more newly formed special purpose entities which will sell certain classes of notes to be secured by the Collateral. The terms of the agreement required the Company to make a $10 million deposit which can be applied against any net loss realized by the advisor if certain defined events occur, which result in the notes not being sold and the Collateral being liquidated; the Company has no liability for net losses in excess of the deposit in the event of liquidation of the Collateral. At March 31, 2002, the financial advisor had purchased $96.1 million of Collateral, which had unrealized losses of less than $0.1 million at March 31, 2002.

NOTE 15. SEGMENT INFORMATION

The Company has separated its financial services into four categories: Domestic Retail Brokerage; Banking; Global and Institutional; and Wealth Management and Other. There have been no changes to these categories from fiscal 2001. As the Wealth Management and Other operations business represents emerging activities which are not currently material to the consolidated results and has characteristics comparable to the offerings of other retail brokerage firms, management has aggregated Wealth Management and Other with Domestic Retail Brokerage to form one of three reportable segments. Corporate administration costs are included in Domestic Retail Brokerage and Other.

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 and Other	Banking	Global and Institutional	Total
Three Months Ended March 31, 2002:				
Interest income—net of interest expense	$ 47,125	$ 53,817	$ 2,033	$ 102,975
Non-interest revenue—net of provision for loan losses	137,157	53,299	37,446	227,902
Net revenues	$ 184,282	$ 107,116	$ 39,479	$ 330,877
Operating income (loss)	$ (2,166)	$ 51,452	$ (4,419)	$ 44,867
Cumulative effect of accounting change	$ (6,823)	$ —	$ (292,590)	$ (299,413)
Three Months Ended March 31, 2001:				
Interest income—net of interest expense	$ 59,648	$ 36,319	$ 2,362	$ 98,329
Non-interest revenue—net of provision for loan losses	158,694	35,295	37,263	231,252
Net revenues	$ 218,342	$ 71,614	$ 39,625	$ 329,581
Operating income (loss)	$ (8,181)	$ 24,460	$ (13,353)	$ 2,926
As of March 31, 2002:				
Segment assets	$ 3,798,734	$ 13,644,793	$ 566,363	$ 18,009,890
As of December 31, 2001:				
Segment assets	$ 4,272,345	$ 13,458,433	$ 441,636	$ 18,172,414

No single customer accounted for greater than 10% of total revenues in the three months ended March 31, 2002 or 2001.

NOTE 16. SUBSEQUENT EVENTS

In April 2002, the Company announced an agreement to acquire privately-held Tradescape Securities, LLC, a direct access brokerage firm for active online traders and Tradescape Technologies' high-speed direct access trading software, technology and network services, including Momentum Securities, LLC, an onsite brokerage firm for individual professional traders, for $100 million of the Company's common stock. In addition, the Company may pay additional contingent stock consideration of up to $180 million payable if Tradescape's operating results exceed certain targets and revenue goals for the remainder of fiscal 2002 and fiscal 2003. The Company expects the acquisition to be completed in the second quarter of fiscal 2002.

In April 2002, ETFC formed ETFC Capital Trust IV ("ETFCCT IV"), a business trust formed solely for the purpose of issuing capital securities, sold at par, 10,000 shares of Floating Rate MMCapS, with a liquidation amount of $1,000 per capital security, for a total of $10.0 million and invested the net proceeds in ETFC's Floating Rate Junior Subordinated Debentures. The Subordinated Debentures mature in 2032 and have a variable annual dividend rate at 3.70% above the six-month LIBOR, payable semi-annually, beginning in October 2002. The net proceeds were used for ETFC's general corporate purposes, which include funding ETFC's continued growth.

In May 2002, the Company purchased 31,250 of newly issued shares in E*TRADE Japan K.K. in exchange for 3.3 million shares of the Company's common stock in a private transaction, valued at $30.7 million. Following the transaction, the Company increased its ownership in E*TRADE Japan K.K. from 29% to 36%.

On May 10, 2002, the Company announced an agreement with its Chairman of the Board and Chief Executive Officer for a two-year employment contract, effective May 15, 2002. The employment contract includes a zero base salary, a return of 2.0 million shares of restricted stock previously granted by the Company, the cancellation of the tax reimbursement feature on the remaining restricted stock under this grant, and a return of certain amounts previously contributed as well as a reduction in the future benefits of the Company's Supplemental Executive Retirement Plan. The Company will record a benefit in the three months ended June 30, 2002, related to amounts previously expensed by the Company for these items.

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

Forward-Looking Statements

*Statements made in this document, other than statements of historical information, are forward-looking statements that are made pursuant to the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements may sometimes be identified by words such as "expect", "may" "looking forward", "we plan", "we believe", "are planned", "could be" and "currently anticipate". Although we believe these statements, as well as other oral and written forward-looking statements made by us or on behalf of E*TRADE Group, Inc. from time to time, to be true and reasonable, we can give no assurance that these plans, intentions or expectations will be achieved. Actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements. Important factors that could cause actual results to differ materially from our forward-looking statements are set forth in our other filings with the Securities and Exchange Commission, commonly referred to as the SEC, and in this document under the heading "Risk Factors", beginning in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations". 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 Financial.*

Results of Operations

Key Performance Indicators

The following table sets forth several key performance indicators which management utilizes in measuring our performance and in explaining the results of our operations for the comparative three months presented:

	Three Months Ended March 31,		
	2002	2001	Percentage Change
Active global brokerage accounts(1)(2)	3,598,216	3,320,356	8%
Active banking accounts(3)	519,154	404,765	28%
Total active accounts at period end	4,117,370	3,725,121	11%
Net new global brokerage accounts(2)	86,275	123,964	(30)%
Net new banking accounts	28,241	42,148	(33)%
Total net new accounts	114,516	166,112	(31)%
Cost per new account	$ 272	$ 387	(30)%
Total global brokerage transactions(2)	6,144,665	8,410,013	(27)%
Daily average global brokerage transactions(2)	102,411	135,645	(25)%
Average commission per global brokerage transaction(2)	$ 13.43	$ 13.77	(2)%
	(in thousands)		
Total assets in global brokerage accounts(2)	$44,657,233	$41,097,776	9%
Total deposits in banking accounts	8,986,184	6,771,024	33%
Total assets/deposits in customer accounts at period end	$53,643,417	$47,868,800	12%

(1) Global brokerage accounts are considered active 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.

(2) Global brokerage account, transaction and asset data includes domestic and international information.

(3) Bank accounts are considered active 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.

The following table sets forth the components of brokerage and banking 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 March 31,		Percentage Change
	2002	2001	
Brokerage revenues:			
Commissions	$ 82,527	$ 115,825	(29)%
Principal transactions	55,315	31,172	77%
Other brokerage-related services	36,761	48,960	(25)%
Interest income	53,051	100,745	(47)%
Interest expense	(3,893)	(38,735)	(90)%
Net brokerage revenues	223,761	257,967	(13)%
Banking revenues:			
Gain on sales of originated loans	24,675	9,184	169%
Gain on sale of loans held-for-sale and securities—net	21,622	19,110	13%
Other banking-related revenues	10,384	8,444	23%
Interest income	202,668	216,685	(6)%
Interest expense	(148,851)	(180,366)	(17)%
Provision for loan losses	(3,382)	(1,443)	134%
Net banking revenues	107,116	71,614	50%
Total net revenues	$ 330,877	$ 329,581	— %

Revenues

Beginning in January 2002, we changed our presentation of revenue from that previously presented; however, no changes to our accounting policies or methods were made. Under the new format, net brokerage revenues consist of commissions, principal transactions, other brokerage-related, interest income and interest expense. Commissions include domestic and international transaction revenues. Previously, international transactions were included under the caption "global and institutional." Principal transactions include revenues from institutional activities, previously included in global and institutional, and market-making activities, previously included in other revenues. Other brokerage-related revenues include account maintenance fees, payments from order flow, Business Solutions Group revenue and mutual fund revenue. Except for order flow, which was previously included in transaction revenues, other brokerage-related items were included in other revenues. Net banking revenues consist of gain on sale of originated loans, gain on sale of loans held-for-sale and securities-net, other banking-related, interest income, interest expense and provision for loan losses. Other banking-related revenues are primarily comprised of automated teller machine revenues.

Total net revenues remained flat from the prior year quarter. Net brokerage revenues decreased 13% while net banking revenues increased 50%. The decrease in brokerage revenues is due to a decrease in commission revenues, other brokerage-related services and interest income from brokerage activities, offset by increases in principal transactions and a decrease in interest expense from brokerage activities. The increase in net banking revenues is mainly due to an increase in gain on sales of originated loans, gain on sale of loans held-for-sale and securities-net and a decrease in interest expense, offset by decreases in interest income and an increase in the provision for loan losses.

Brokerage Revenues

Commission revenues, which are earned as customers execute securities trades, decreased 29% from the prior year quarter. These revenues are primarily affected by global brokerage transaction volume and the average commission per global brokerage transaction. Daily average global brokerage transactions decreased 25% from the prior year quarter, largely reflective of the market downturn and a slight decrease in the average commission per global brokerage transaction from $13.77 for the three months ended March 31, 2001 to $13.43 for the three months ended March 31, 2002. The decrease in commission revenues is primarily related to transaction mix. The most significant change was a 14% decrease in option transactions, which have higher commissions than equity transactions, and a 40% increase in listed market order transactions, which are $14.95, below our standard equity commission of $19.95.

Principal transactions, which comprise our institutional and market-making revenues, increased 77% from the prior year quarter. This increase is due primarily from market-making revenues from Dempsey and Company LLC ("Dempsey") of approximately $24.5 million for the three months ended March 31, 2002. There were no revenues from market-making activities prior to the acquisition of Dempsey in October 2001.

Other brokerage-related services revenues, which are mainly comprised of payments from order flow, account maintenance fees, Business Solutions Group revenue and mutual fund revenues, decreased 25% from the prior year quarter. This decrease is primarily due to a decrease in order flow. Revenue from order flow is comprised of rebate income from various market makers, including Dempsey, and market centers for processing transactions through them. We use Dempsey and other broker-dealers to execute our customers' orders. 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. This decrease is due to competitive forces and the advent of decimalization in the major market exchanges beginning in January 2001 and implemented by Nasdaq in March 2001. Further, following the acquisition of Dempsey in October 2001, rebate income from order flow executed through Dempsey is now eliminated in our consolidation of operating results.

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.

Brokerage interest income decreased 47% from the prior year quarter. The decrease in brokerage interest income primarily reflects the decrease in average customer margin balances, which decreased by 48% from the prior year quarter. The continued decline in the Nasdaq, Dow Jones Industrial Average and S&P 500 indices over the past year and the economic recession has reduced borrowing on margin by customers as a means of leveraging their investments. Brokerage interest expense decreased 90% from the prior year quarter. The decrease in brokerage interest expense primarily reflects an overall decrease in average customer credit rates and average stock loan balances, which decreased 80%. Net brokerage interest income decreased 21% from the prior year quarter primarily due to the effects of the economic recession that has affected the asset value of customer investment portfolios and in turn, average margin balances. This decrease adversely affects 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 and average stock loan balances for the three months indicated:

	Three Months Ended March 31,		
	2002	2001	Percentage Change
(dollars in millions)			
Average customer margin balances	$ 1,503	$ 2,866	(48)%
Average customer money market fund balances	$ 8,451	$ 8,596	(2)%
Average stock loan balances	$ 515	$ 2,594	(80)%

Banking Revenues

Gain on sales of originated loans increased 169% from the prior year quarter. This increase is due to an increased level of volume of originations in the March 2002 quarter as compared to the prior year quarter. In addition, as E*TRADE Mortgage was acquired by the Company in February 2001, the Company has been able to benefit from an entire quarter of activity in fiscal 2002 as compared to fiscal 2001.

Gain on sale of loans held-for-sale and securities-net consist primarily of gains on sales of Bank loans held-for-sale, available-for-sale mortgage-backed and investment securities, trading activity and gains related to derivative financial instruments. Gains on sales of loans held-for-sale and securities-net increased 13% from the prior year quarter. The increase is due to a significant increase in gains on sales of Bank loans purchased from correspondents which increased 82% from the prior year quarter. The increase was partially offset by a 72% decrease in gains on sales of available-for-sale securities. In addition, we recorded approximately $8.6 million of gains on derivative financial instruments, which occurred after the discontinuance of hedge accounting, for the three months ended March 31, 2002, as compared to $3.4 million of losses recognized during the three months ended March 31, 2001.

Other banking-related revenues are comprised primarily of ATM fees. Other banking-related revenues increased 23% from the prior year quarter. This increase is due to higher ATM transaction surcharge volume, primarily caused by a 16% increase in the number of ATMs in our network from March 31, 2001 to March 31, 2002.

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 incurred through interest-bearing banking liabilities that include customer deposits, advances from the FHLB and other borrowings.

Banking interest income decreased 6% from the prior year quarter. Decreases in banking interest income reflect decreases in average yield, partially offset by increases in average interest earning banking asset balances. Average interest-earning banking assets increased 16% from the prior year quarter. The average yield on interest-earning banking assets decreased to 6.00% in the three months ended March 31, 2002 from 7.47% in the three months ended March 31, 2001.

Banking interest expense decreased 17% from the prior year quarter. The decrease in banking interest expense reflects a decrease in the average cost of the borrowings partially offset by an increase in the average interest-bearing banking liability balances. Average interest-bearing banking liability balances increased 15% from the prior year quarter. The average cost of borrowings decreased to 4.73% in the three months ended March 31, 2002 from 6.62% in the three months ended March 31, 2001. The increase in the average net interest spread from 0.85% in the three months ended March 31, 2001 to 1.27% in the three months ended March 31, 2002, is primarily a result of the decreased costs of retail deposits and lower interest rates on short term borrowings, partially offset by expenses of hedging activity. Average retail deposits in banking accounts increased 38% from the prior year quarter.

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 months ended March 31, 2002 and March 31, 2001. 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 March 31, 2002			Three Months Ended March 31, 2001		
	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	$ 8,001,940	$ 132,385	6.62%	$ 5,705,108	$ 111,342	7.81%
Interest-bearing deposits	287,306	1,689	2.38%	39,825	642	6.54%
Mortgage-backed and related available-for-sale securities	3,979,005	52,787	5.31%	4,803,455	85,438	7.11%
Available-for-sale investment securities	1,123,416	14,318	5.14%	843,772	15,487	7.39%
Investment in FHLB stock	58,515	1,139	7.89%	83,358	1,490	7.25%
Trading securities	53,755	350	2.60%	128,797	2,286	7.10%
Total interest-earning banking assets	13,503,937	$ 202,668	6.00%	11,604,315	$ 216,685	7.47%
Non-interest-earning banking assets	579,013			303,709		
Total banking assets	$ 14,082,950			$ 11,908,024		
Interest-bearing banking liabilities:						
Retail deposits	$ 8,505,812	94,469	4.50%	$ 6,169,462	$ 100,068	6.58%
Brokered callable certificates of deposit	20,261	125	2.51%	91,644	1,425	6.31%
FHLB advances	924,233	14,679	6.35%	1,625,322	27,599	6.79%
Other borrowings	3,301,971	39,578	4.79%	3,160,833	51,274	6.49%
Total interest-bearing banking liabilities	12,752,277	$ 148,851	4.73%	11,047,261	$ 180,366	6.62%
Non-interest bearing banking liabilities	605,488			208,214		
Total banking liabilities	13,357,765			11,255,475		
Total banking shareowner's equity	725,185			652,549		
Total banking liabilities and shareowner's equity	$ 14,082,950			$ 11,908,024		
Excess of interest-earning banking assets over interest-bearing banking liabilities/net interest income	$ 751,660	$ 53,817		$ 557,054	$ 36,319	
Net interest spread			1.27%			0.85%
Net interest margin (net yield on interest-earning banking assets)			1.60%			1.26%
Ratio of interest-earning banking assets to interest-bearing banking liabilities			105.89%			105.04%
Return on average total banking assets			0.85%			0.44%
Return on average net banking assets			16.57%			8.12%
Average equity to average total banking assets			5.15%			5.48%

Loans Receivable and Provision for Loan Losses

The provision for loan losses recorded reflects adjustments 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 was $3.4 million in the three months ended March 31, 2002 and $1.4 million in the three months ended March 31, 2001. The increase in the provision for loan losses primarily reflects the growth in and composition of our Banking loan portfolio as well as the Bank's decision to invest a greater portion of its assets in loans with higher yields, and therefore, increased credit risk, such as automobile loans. As of March 31, 2002, the total loan loss allowance was $16.7 million, or 0.24% of total loans outstanding and 71% of total non-performing loans of $23.5 million. As of December 31, 2001, the total loan loss allowance was $19.9 million, or 0.25% of total loans outstanding and 96% of total non-performing loans of $20.7 million.

The following table presents information concerning our banking loan portfolio as of March 31, 2002 and December 31, 2001, by type of loan:

	March 31, 2002		
(dollars in thousands)	Held-for-Investment	Held-for-Sale	Total Loans
Real estate loans:			
One-to four-family	$ 4,522,603	$ 864,245	$ 5,386,848
Multi-family	113	—	113
Commercial	16,819	—	16,819
Mixed-use	586	—	586
Consumer and other loans:			
Automobiles, mobile homes and recreational vehicles	1,526,715	—	1,526,715
Home equity lines of credit and second mortgage loans	71,578	315	71,893
Other	10,476	—	10,476
Total loans	6,148,890	864,560	7,013,450
Unamortized premiums (discounts), net	38,995	(662)	38,333
Less allowance for loan losses	(16,699)	—	(16,699)
Total	$ 6,171,186	$ 863,898	$ 7,035,084

	December 31, 2001		
	Held-for-Investment	Held-for-Sale	Total Loans
Real estate loans:			
One-to four-family	$ 4,696,681	$ 1,621,783	$ 6,318,464
Multi-family	183	—	183
Commercial	1,981	—	1,981
Mixed-use	635	—	635
Consumer and other loans:			
Automobiles, mobile homes and recreational vehicles	1,635,050	—	1,635,050
Home equity lines of credit and second mortgage	22,720	339	23,059
Other	12,188	49	12,237
Total loans	6,369,438	1,622,171	7,991,609
Unamortized premiums (discounts), net	44,804	(6,082)	38,722
Less allowance for loan losses	(19,874)	—	(19,874)
Total	$ 6,394,368	$ 1,616,089	$ 8,010,457

The following table presents information about our non-accrual loans and repossessed assets as of the periods indicated:

(dollars in thousands)	March 31, 2002	December 31, 2001
Loans accounted for on a non-accrual basis:		
Real estate loans:		
One-to four-family	$ 22,065	$ 20,595
Commercial	9	—
Automobiles, mobile homes and recreational vehicles	1,430	91
Total non-performing loans	23,504	20,686
Repossessed assets	3,162	3,328
Total non-performing assets	$ 26,666	$ 24,014
Total non-performing loans as a percentage of held-for-investment loans	0.38%	0.32%
Total non-performing assets as a percentage of held-for-investment loans	0.43%	0.37%
Total non-performing assets as a percentage of total banking assets	0.20%	0.18%
Total loan loss allowance as a percentage of total non-performing loans	71.05%	96.07%

The total loan loss allowance, as a percentage of total non-performing loans, decreased from 96.07% as of December 31, 2001, to 71.05% as of March 31, 2002. The Bank's total loan portfolio decreased from $8.0 billion to $7.0 billion during the quarter due to principal prepayments and several large bulk loan sales. Allocations to the total loan loss allowance are a function of both the performing and non-performing loans. The aggregate reduction in the total loan portfolio resulted in a reduction of the total loan loss allowance from December 31, 2001 to March 31, 2002. The method for determining the appropriate total loan loss allowance did not change during the quarter, and the current level of the loan loss allowance is considered appropriate.

Interest income is not accrued for loans classified as non-performing and any income accrued through the initial 90-day delinquency is reversed. Had these loans performed, additional income of $0.4 million during the quarter ended March 31, 2002 and $0.3 million during the quarter ended March 31, 2001 would have been recognized. As of March 31, 2002 and 2001, there were no commitments to lend additional funds to these borrowers.

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

	Three Months Ended March 31,	
	2002	2001
	(in thousands)	
Allowance for loan losses, beginning of the period	$ 19,874	$ 12,565
Provision for loan losses	3,382	1,443
Charge-offs, net	(6,557)	(187)
Allowance for loan losses, end of period	$ 16,699	$ 13,821

The average recorded investment in impaired loans for the three months ended March 31, 2002 was $2.4 million and $1.9 million for the three months ended March 31, 2001. The Company's charge-off policy for impaired loans is consistent with its charge-off policy for other loans; impaired loans are charged-off when, in the opinion of management, all principal and interest due on the impaired loan will not be fully collected. Consistent with the Company's method for non-accrual loans, payments received on impaired loans are recognized as interest income or applied to principal when it is doubtful that full payment will be collected. For the three months ended March 31, 2002 and 2001, the Company had no restructured loans.

For the three months ended March 31, 2002, the Company's charge-offs were greater than the recorded provision for loan losses. In the fourth quarter of fiscal 2001, the Company purchased certain pools of automobile and recreational vehicle loans that included certain delinquent accounts. The Company recorded an increase to its allowance for loan loss in the fourth quarter of fiscal 2001 in connection with the acquisition of these loan pools. During the three months ended March 31, 2002, the Company had charge-offs against the recorded allowance for the acquired delinquent loans.

Operating Expenses

The following table sets forth the components of cost of services and operating expenses and percentage change information for the three months ended March 31, 2002 and 2001:

(dollars in thousands)	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001	Percentage Change
Cost of services	$140,752	$142,435	(1)%
Cost of services as a percentage of net revenues	43%	43%	
Operating expenses:			
Selling and marketing	$ 68,964	$ 93,698	(26)%
Technology development	14,504	22,281	(35)%
General and administrative	54,029	60,242	(10)%
Amortization of goodwill and other intangibles	6,724	7,999	(16)%
Merger-related expenses	1,260	—	*
Facility restructuring and other nonrecurring charges	(223)	—	*
Total operating expenses	$145,258	$184,220	(21)%

* Percentage change not meaningful.

Cost of Services

Cost of services as a percentage of net revenues remained flat at 43% in the three months ended March 31, 2002 and 2001. 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. We have been able to maintain cost of services relatively flat as a percentage of net revenues in the three months ended March 31, 2002 compared to the three months ended March 31, 2001 due to facility restructuring efforts implemented in August 2001 which reduced our ongoing lease costs related to vacated facilities, offsetting increases from the addition of E*TRADE Mortgage during the latter part of the first quarter in 2001.

Selling and Marketing

Selling and marketing expenses decreased 26% from the prior year quarter. 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. The decrease in selling and marketing expenses from the prior year quarter is primarily due to reductions in customer acquisition spending, including advertising, online, direct mailing and promotional activities, which are expected to remain at lower than prior year levels. Cost per new account decreased from $387 in the three months ended March 31, 2001 to $272 in the three months ended March 31, 2002, due to acquisitions and the deepening of our product penetration with our customers through the recent expansion into the automobile and home equity line of credit loan markets, which have lower costs per new account. Going forward, our focus will be on developing current customer households, continuing to deepen product penetration and increasing assets per household instead of cost per new account. Acquisitions will focus on new households via core Bank and Brokerage business and leveraging our sales channels to cross-sell other financial products to our customer base. Looking forward, we expect that marketing expenditure levels will be in the range of 17% to 20% of net revenues, lower than during the fiscal year ended December 31, 2001. If general market conditions improve, we will explore the possibility of increasing our spending.

Technology Development

Technology development expenses decreased 35% from the prior year quarter. Technology development projects enhanced our existing product offerings and developed new functionality and features. Completion of development projects for CRM, international locations, internal systems and promotional capabilities during 2001 allowed us to reduce the use of outside consultants and related expenses versus the same quarter last year. We believe our focused technology development efforts will continue to position E*TRADE Financial as a leading provider of online financial services. Our current capacity and capabilities are expected to meet projected business requirements.

General and Administrative

General and administrative expenses decreased 10% from the prior year quarter. General and administrative expenses decreased primarily as a result of an initial $9.6 million compensation charge recognized in the three months ended March 31, 2001 related to the vesting of funds contributed to our Supplemental Executive Retirement Plan (“SERP”) upon its adoption. Also contributing to the decrease are reductions realized from our recent restructuring plans initiated in fiscal 2001. Offsetting these decreases were increases in costs associated with our fiscal 2001 acquisitions of Web Street and Dempsey. In addition, E*TRADE Mortgage, which was acquired by us in February 2001, did not have significant costs for the three months ended March 31, 2001.

Amortization of Goodwill and Other Intangibles

Amortization of goodwill and other intangibles was $6.7 million for the three months ended March 31, 2002 and $8.0 million for the three months ended March 31, 2001. The decrease in the amortization of goodwill and other intangibles primarily relates to our ceasing of goodwill amortization upon adoption of SFAS No. 142 *Goodwill and Other Intangible Assets* on January 1, 2002. The amortization expense for the three months ended March 31, 2002 relates to our other intangible assets from acquisitions including E*TRADE Access, which was acquired during fiscal 2000, the acquisitions of WebStreet, E*TRADE Mortgage, Dempsey and certain deposit accounts from Advanta National Bank, a subsidiary of Advanta Corporation, in fiscal 2001 and the acquisition of certain customer deposit accounts from Chase Manhattan Bank USA, National Association in February 2002.

Merger-Related Expenses

Merger-related expenses were $1.3 million for the three months ended March 31, 2002 and primarily represent management continuity payments associated with our acquisition of Dempsey.

Facility restructuring and other nonrecurring charges

Facility restructuring and other nonrecurring charges reflected a credit of $0.2 million for the three months ended March 31, 2002. This credit is comprised of adjustments related to our prior estimated charges that have been revised to reflect current estimates and/or resolution of certain of these costs. See Note 3 to the Condensed Consolidated Financial Statements.

Non-Operating Income (Expenses)

Corporate interest income was $3.6 million for the three months ended March 31, 2002 and $5.8 million for the three months ended March 31, 2001. Corporate interest income includes interest income earned on corporate investment balances and related party notes. The decrease in corporate interest income was primarily due to lower interest yields earned on these corporate investments as market rates have declined. Further, corporate interest income reflects a decrease in the related party note balance on the remaining related party notes.

Corporate interest expense was $12.4 million for the three months ended March 31, 2002 and $11.2 million in the three months ended March 31, 2001. Corporate interest expense for the three months ended March 31, 2002 and 2001 primarily relates to interest expense resulting from the issuance of our convertible subordinated notes during fiscal 2001 and fiscal 2000. During the three months ended March 31, 2001, we had $650 million outstanding convertible subordinated notes at 6.00%. In May 2001, we issued an additional $325 million of convertible subordinated notes at 6.75%. This increase in convertible subordinated notes was offset by an exchange of approximately $265 million of our 6.00% notes, resulting in a net increase in our convertible subordinated notes and related interest expense for the three months ended March 31, 2002.

Gain (loss) on sale of investments was $1.7 million for the three months ended March 31, 2002 and $(2.5) million for the three months ended March 31, 2001. For the three months ended March 31, 2002, we recognized a gain of $1.7 million on one of our investments. For the three months ended March 31, 2001, we liquidated a portion of our investment portfolio, recognizing realized losses on the sale of a publicly-traded equity security.

Equity in income (losses) of investments was $0.3 million for the three months ended March 31, 2002 and $(3.3) million for the three months ended March 31, 2001 which resulted from our minority ownership in investments that are accounted for under the equity method. These investments primarily include E*TRADE Japan K.K. for the three months ended March 31, 2002 and E*TRADE Japan K.K., eAdvisor and SoundView Technology Group, Inc., for the three months ended March 31, 2001.

For the three months ended March 31, 2002, we recorded unrealized losses on venture funds of $1.8 million, primarily attributable to the Softbank Capital Partners, L.P. venture fund. For the three months ended March 31, 2001, we recorded unrealized losses on venture funds of $11.6 million, primarily attributable to the Softbank Capital Partners, L.P. and E*TRADE eCommerce Fund, L.P. venture funds. Unrealized losses on venture funds represent market fluctuations on public investments held by the funds and changes in the estimated value of the non-public investments.

For the three months ended March 31, 2002 and for the three months ended March 31, 2001, we recorded a $(1.0) million and a $0.3 million pre-tax gain (loss), respectively, for the fair value adjustments of financial derivatives. The gain (loss) represent a $(0.9) million loss and $1.4 million gain representing the ineffective portions of changes in the fair value of hedges offset by a $0 and $1.1 million loss on the valuation of warrants, respectively.

Other non-operating expense was $1.0 million for the three months ended March 31, 2002 and $0.7 million for the three months ended March 31, 2001. Other non-operating expense was primarily a result of fluctuations in foreign exchange rates for assets and liabilities held on our balance sheet that are denominated in non-functional currencies and fixed asset disposals.

Income Tax Expense (Benefit)

Income tax expense (benefit) represents the federal and state income taxes at an effective tax rate of 43.0% for the three months ended March 31, 2002 and (65.0)% for the three months ended March 31, 2001. The rate for the three months ended March 31, 2002 reflects an increase in tax for our valuation allowance for capital losses and differences between our statutory and foreign effective tax rate, and a decrease in taxes due to the research and development income tax credit and state tax planning. The rate for the three months ended March 31, 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.

Minority Interest in Subsidiaries

Minority interest in subsidiaries was $0.2 million for the three months ended March 31, 2002 and $35,000 for the three months ended March 31, 2001. 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 ETFC. Also included in minority interest in subsidiaries for the three months ended March 31, 2002 and 2001 is the net loss attributed to a minority interest in one of our international affiliates. In the three months ended March 31, 2002, we consolidated the results of eAdvisor, a joint venture previously accounted for under the equity method. As a result, minority interest in subsidiaries for the three months ended March 31, 2002 also includes a minority interest in eAdvisor. See Note 1 to the Condensed Consolidated Financial Statements.

Extraordinary Gain (Loss) on Early Extinguishment of Debt

Extraordinary gain (loss) on early extinguishment of debt was $4.1 million for the three months ended March 31, 2002 and $(2.0) million for the three months ended March 31, 2001. For the three months ended March 31, 2002, we recorded an extraordinary gain on early extinguishment of debt of $4.1 million (net of tax expense of $2.7 million) from the retirement of $50 million of our 6.00% convertible subordinated notes in exchange for approximately 4.7 million shares of our common stock. For the three months ended March 31, 2001, we recorded an extraordinary loss on early extinguishment of debt of $2.0 million (net of tax benefit of $1.2 million) from the early redemption of $400 million of adjustable and fixed rate advances with the FHLB. The FHLB advances were entered into as a result of normal funding requirements of our banking operations.

In April 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 145, *Rescission of FASB Statement No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.* SFAS 145 requires that any gains or losses on extinguishment of debt that were classified as an extraordinary item in prior periods that are not unusual in nature and infrequent in occurrence be reclassified to other income (expense), beginning in fiscal 2003, with early adoption encouraged. The Company is currently evaluating when to adopt the requirements of SFAS No. 145 in its consolidated financial statements.

Cumulative Effect of Accounting Change

Cumulative effect of accounting change was $299.4 million for the three months ended March 31, 2002. The accounting change was due to our adoption of SFAS No. 142; whereby we reviewed our goodwill for impairment using the fair market value test and as a result wrote-down goodwill associated with some of our international subsidiaries acquired in the previous years. As required under SFAS No. 142, we will continue to review at least annually the impairment (if any) of all of our goodwill positions and record future impairment charges to operating expenses. See Note 2 to the Condensed Consolidated Financial Statements.

Liquidity and Capital Resources

Debt Retirements

For the three months ended March 31, 2002, we retired $50 million of our 6.00% convertible subordinated notes in exchange for approximately 4.7 million shares of our common stock.

Technology Center Financing

On July 30, 1999, we entered into a lease agreement for our 164,500 square foot technology operation center located near Atlanta, Georgia. To secure the lease, we posted cash collateral, which was $71.9 million at December 31, 2001. On March 27, 2002, we exercised our purchase option, and used the cash collateral to fund the purchase on April 29, 2002. As a result, we have included the property and related payable for the purchase of $71.9 million on the Consolidated Balance Sheet. The cash collateral is included in cash and equivalents as of March 31, 2002, and was used to purchase the property in April 2002.

Other Sources of Liquidity

We have financing facilities totaling $275 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 were no borrowings outstanding under these lines as of March 31, 2002. In addition, we have a short-term line of credit for up to $50 million, collateralized by marketable securities owned by us, of which there were no outstanding borrowings as of March 31, 2002. We also have three term loans collateralized by equipment owned by us and one installment purchase contract, of which $12.8 million was outstanding as of March 31, 2002. We have also entered into numerous agreements with other broker-dealers to provide financing under our stock loan program.

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 decreased. The recognition of unrealized losses of these equity investments impacts our liquidity. Depreciation in the market value of our portfolio impacts our financing strategies that 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 "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 "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 provided by operating activities was $579.4 million for the three months ended March 31, 2002. Cash used in operating activities resulted primarily from net loss of $276.0 million, adjusted for non-cash items totaling $357.2 million (including cumulative effect of accounting change of $299.4 million, depreciation and amortization expenses, including discount accretion, of $47.6 million, change in deferred taxes of $19.5 million, gains on sales of investments of $5.4 million and extraordinary gain on early extinguishment of debt of $4.1 million), an increase in bank-related liabilities in excess of assets of $633.6 million, offset by an increase in brokerage-related assets in excess of liabilities of $70.7 million. Cash used in operating activities, net of effects from acquisitions, was $92.5 million for the three months ended March 31, 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 $196.6 million and an increase in other assets of $55.7 million, partially offset by depreciation, amortization and discount accretion of $36.1 million and an increase in brokerage-related liabilities in excess of assets, net of effects from acquisitions of $111.4 million.

Cash used in investing activities was $448.2 million for the three months ended March 31, 2002 and $455.1 million for the three months ended March 31, 2001. For the three months ended March 31, 2002, cash used in investing activities resulted primarily from purchases of securities in excess of sale/maturity of $691.5 million offset by a decrease in loans receivable of $223.1 million. For the three months ended March 31, 2001, cash used in investing activities resulted primarily from an increase in loans receivable of $928.8 million and purchases of property and equipment of $62.7 million, partially offset by an excess of the net sale/maturity of investments over the purchases of investments of $535.0 million.

Cash provided by financing activities was $117.9 million for the three months ended March 31, 2002 and $505.6 million for the three months ended March 31, 2001. For the three months ended March 31, 2002 and 2001, cash provided by financing activities primarily resulted from an increase in banking deposits and net advances from the FHLB, offset by decreases in securities sold under agreements to repurchase and other borrowed funds.

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 retail and institutional brokerage firms, banks, thrifts and other financial institutions, mortgage companies, specialists, market makers, insurance companies, electronic communication networks ("ECNs"), mutual fund companies, credit card companies, Internet portals, equity compensation product providers and other organizations, including, among others:

- American Express Company
- AOL Time Warner Inc.
- Ameritrade, Inc. (including its subsidiary, National Discount Brokers Corporation)
- Bank of America Corporation
- bankone.com (a division of Bank One Corp.)
- Charles Schwab & Co., Inc. (including Schwab Capital Markets)
- CNBC MoneyCentral
- Citigroup Inc.
- Countrywide Home Loans, Inc.
- Datek Online Financial Services LLC (a subsidiary of Datek Online Holdings Corporation)
- Deutsche Bank
- E-Loan, Inc.
- Fidelity Investments
- FleetBoston Financial Corporation
- GMAC Mortgage Corporation d/b/a ditech.com
- Harris*direct* (formerly CSFBdirect)
- Hoenig Group Inc.
- Instinet Group, Inc. (a unit of Reuters Group)
- Island ECN
- Intuit Inc.
- J.P. Morgan Chase & Co.
- Knight Securities (a division of Knight Trading Group, Inc.)
- Merrill Lynch, Pierce, Fenner & Smith Incorporated (including Herzog, Heine, Gould)
- Morgan Stanley Dean Witter & Co.
- NetBank, Inc.
- PaineWebber Group, Inc. (owned by UBS AG)

- Salomon Smith Barney, Inc. (owned by Citigroup)
- Spear Leeds & Kellog (a division of Goldman Sachs Group, Inc.)
- TD Waterhouse Group, Inc.
- Transcentive, Inc.
- Wells Fargo & Company
- 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, alliances or consolidation (as described below) among existing competitors may significantly reduce our market share or our ability to compete effectively.

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 and more competitive with our banking operations by offering products electronically. 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.

If we do not act or are unable to take advantage of consolidation opportunities in the online financial services industry, we could be at a competitive disadvantage, or lose our independence

Over the past several years, there has been significant consolidation in the online financial services industry and the consolidation is likely to continue and even accelerate in the future. Should we fail to take advantage of viable consolidation opportunities we could be placed at a disadvantage relative to our competitors who have taken appropriate advantage of these opportunities.

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 every aspect of our businesses, we must protect our computer systems and network from break-ins, security breaches, both physical (e.g., at our ATMs and retail locations) and electronic (e.g., through "hacking"), 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 been in the past, and could be in the future, subject to denial of service, vandalism and other attacks on our systems. We rely on encryption and authentication technology, including cryptography technology licensed from a third party provider, 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 or publication of private information by persons with authorized access to our computer systems, including individuals employed by us. 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 or disruptions in the securities markets 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 terrorist attacks in the United States on September 11, 2001, for example, resulted in the closing of U.S. financial markets for an unprecedented four days. Future disruption could cause further decreased activity and may result in the continuation of market volatility and decreased investor activity referred to below. 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, 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. The possibility exists that U.S. securities markets will continue to be volatile and that prices and transaction volumes will 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.

Downturns in the securities markets increase the risk that parties to margin lending or stock loan 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 or stock loan 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. Similarly, as part of our broker-dealer operations, we frequently enter into arrangements with other broker-dealers for the lending of various securities. 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 counterparties to the borrowing and lending transactions fail to honor their commitments. The significant downturn in equity markets since its record high in March 2000 has led to a greater risk that parties to stock lending transactions may fail to meet their commitments. Any such losses could harm our financial position and results of operations.

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

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, the processing of brokerage orders or the promotion and processing of insurance products that need review or could slow the growth in our customer accounts, and that could harm our business, financial condition and operating results. Competition for such personnel is intense when transactions in our various products 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 of the Board and Chief Executive Officer, our President, Members of the Office of the President, Chief Financial Officer, our Board of 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, our ATM network, 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, including any such degradation or interruption that is part of a widespread, concerted terrorist attack or computer virus could cause substantial customer losses and 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 or "holes" 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.

In addition, we have recently consolidated certain of our computer systems to provide for operational efficiencies. This consolidation has reduced the redundancies that were inherent in our systems to lessen or avoid the effects of interruptions in certain of our systems. 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.

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

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 affect interest rates, including governmental monetary policies and domestic and international economic and political conditions. Currently, the Bank's net interest income would be harmed by material fluctuations in interest rates.

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 we adopted on October 1, 2000, requires that the hedge ineffectiveness, or the difference between the changes 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 reporting requirement.

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, such as automobile loans and recreational vehicle loans, 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 loan loss allowance would be required. The increased level of provision for loan losses recorded to meet additional loan loss allowance requirements could adversely impact our financial results if those higher yields do not cover the provision for loan losses.

We rely on a number of third parties to process our transactions or provide information, products or services to our customers and their inability to meet our needs and those of our customers 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 or provide information, products or services to our customers, including online and Internet service providers, back office processing organizations, market makers and other service providers. If any of these third parties are unable to sufficiently meet our needs or those of our customers for any reason (including technology failures, capacity failures or their own bankruptcies), our business could be harmed.

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 innovate by developing and enhancing 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.

Risks associated with trading transactions at our specialist/market maker could result in trading losses

A majority of our specialist and market maker revenues at Dempsey are derived from trading by Dempsey as a principal. Dempsey may incur trading losses relating to the purchase, sale or short sale of securities for its own account. In any period, Dempsey also may incur trading losses in its specialist stocks and market maker stocks for reasons such as price declines, lack of trading volume and the required performance of specialist and market maker obligations. From time to time, Dempsey may have large position concentrations in securities of a single issuer or issuers engaged in a specific industry. In general, because Dempsey's inventory of securities is marked to market on a daily basis, any downward price movement in those securities will result in a reduction of our revenues and operating profits. Dempsey also operates a proprietary trading desk separately from its specialist and market maker operations. We may incur trading losses as a result of these trading activities.

Although we have adopted risk management policies at Dempsey, we cannot be sure that these policies have been formulated properly to identify or limit Dempsey's risks. Even if these policies are formulated properly, we cannot be sure that we will successfully implement these policies at Dempsey. As a result, we may not be able to manage our risks successfully or avoid trading losses at Dempsey.

Reduced spreads in securities pricing, levels of trading activity and trading through market makers and/or specialists could harm our specialist and market maker business

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. As a result, spreads that specialists and market makers receive in trading equity securities have declined and may continue to decline, which could harm revenues generated by Dempsey and, in turn, harm our operating results. Similarly, a reduction in the volume and/or volatility of trading activity could also reduce spreads that specialists and market makers receive, also harming revenues generated by Dempsey and, in turn, our operating results.

Alternative trading systems that have developed over the past few years could also reduce the levels of trading of exchange-listed securities through specialists and the levels of over-the-counter trading through market makers, also potentially harming Dempsey's, and in turn, our revenues. We cannot assure that these developments will not cause a decrease in the transaction volumes of Dempsey's specialist operations.

In addition, ECNs have emerged as an alternative forum to which broker-dealers and institutional investors can direct their limit orders. This allows broker-dealers and institutional investors to avoid directing their trades through market makers. As a result, Dempsey may experience a reduction in its flow of limit orders. It is possible that ECNs will continue to capture a greater amount of limit order flow.

If our Business Solutions Group products fail, we could be subject to litigation and our reputation may be harmed

Among others, our Business Solutions Group 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. By their nature, these products and services are highly technical and intricate, dealing with issues which could result in significant accounting and tax reporting inaccuracies for our customers. If our efforts to protect ourselves from product design limitations and/or potential human error, or our efforts to limit our potential exposure, prove inadequate, these inaccuracies could subject us to customer litigation and damage our reputation.

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 the Bank 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 European Union'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 acceptance and 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, including their failure to follow proper practices with respect to their own corporate governance, 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 reputation is higher.

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

In recent years, we have acquired E*TRADE Access, eInvesting, E*TRADE Advisory Services, E*TRADE Technologies, E*TRADE Mortgage, Web Street, several of our international affiliates and Dempsey. 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,
- existence of undetected problems or potential liabilities that could have a significant, negative impact on the business or operations of the acquired company,
- 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 or that any of our future acquisitions will not be dilutive to earnings.

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 $325 million in 6.75% convertible subordinated notes, offset in part by the retirement of $265 million of our 6% convertible subordinated notes in June 2001 through March 2002, we have incurred $60 million of additional convertible indebtedness. Combined with a decrease in shareowners' equity from March 31, 2001 reflecting the facility restructuring and nonrecurring charge and the effects of the share buyback program, our ratio of debt (our convertible debt, capital lease obligations and term loans) to equity (expressed as a percentage) increased from approximately 51% as of December 31, 2001 to approximately 55% as of March 31, 2002. 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.

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 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.

Our efforts to expand recognition of the E*TRADE brand to areas of the financial services industry other than online trading may not be effective

As we diversify the scope of the products and services we offer, the brand "E*TRADE" or "E*TRADE Financial" may not be as effective for us in the future, which could harm our revenues. In addition, our efforts to further our brand as a diversified financial services institution are 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, stock incentive plans, contracts and management retention agreements 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 the Company 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 the Company that do not offer an adequate price to all shareowners or are otherwise not in the best interests of the Company and our shareowners. In addition, certain provisions of our stock incentive plans, management retention and employment agreements (including severance payments, stock option acceleration and loan forgiveness with associated tax gross-ups), 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 and banking industries in the United States are subject to extensive regulation under both federal and state laws. 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. We are also subject to additional laws and rules as a result of our specialist and market maker operations in Dempsey.

Similarly, E*TRADE Group and ETFC, as savings and loan holding companies, and E*TRADE 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, transactions with affiliates and conduct and qualifications of personnel.

In addition, our Business Solutions Group manages equity compensation arrangements that are highly regulated and governed by strict accounting rules. Changes to the regulations governing such arrangements could reduce their widespread use or eliminate such arrangements altogether.

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. Over time, the Gramm-Leach-Bliley Act will have a material impact on the competitive landscape that we face. Similarly, in February 2001, the SEC approved amendments to National Association of Securities Dealers ("NASD") Rule 2520 governing margin requirements for “pattern day traders” which became 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. In addition, the recent enactment of the USA PATRIOT Act of 2001 and associated actions by various regulatory and industry organization and money laundering regulations issued by the U.S. Treasury Department will impose significant new “suspicious activity” reporting and other requirements on banks and securities broker-dealers.

There can be no assurance that federal, state or foreign agencies will not further regulate our business. 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, banking and insurance 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, among other things, 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 compliance system. 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 March 31, 2002:

	Required Net Capital	Net Capital	Excess Net Capital
		(in thousands)	
E*TRADE Securities	$ 35,419	$145,307	$ 109,888
E*TRADE Institutional Securities, Inc.	$ 309	$ 8,426	$ 8,117
E*TRADE Marquette Securities, Inc.	$ 250	$ 521	$ 271
E*TRADE Global Asset Management, Inc.	$ 342	$ 20,529	$ 20,187
E*TRADE Canada Securities Corporation	$ 100	$ 241	$ 141
Web Street Securities and subsidiary	$ 250	$ 941	$ 691
Dempsey	$ 486	$ 14,899	$ 14,413
GVR, LLC	$ 1,000	$ 3,727	$ 2,727

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 Core Capital to adjusted tangible assets. To satisfy the capital requirements for a well capitalized financial institution, a bank must maintain minimum Total and Tier 1 Capital to risk-weighted assets and Core Capital to adjusted tangible assets ratios as set forth in the following table.

The table below summarizes the capital adequacy requirements for the Bank as of March 31, 2002:

	Actual		Well Capitalized Requirements	
	Amount	Ratio	Amount	Ratio
(dollars in thousands)				
Total Capital to risk-weighted assets	$869,387	12.51%	>$694,933	>10.0%
Tier 1 Capital to risk-weighted assets	$852,808	12.27%	>$416,960	> 6.0%
Core Capital to adjusted tangible assets	$852,808	6.27%	>$679,622	> 5.0%

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 affect 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 September 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.

Specialist rules may require Dempsey to make unprofitable trades or to refrain from making profitable trades

Dempsey's role as a specialist, at times, requires it to make trades that adversely affect its profitability. In addition, as a specialist, Dempsey is at times required to refrain from trading for its own account in circumstances in which it may be to Dempsey's advantage to trade. For example, Dempsey may be obligated to act as a principal when buyers or sellers outnumber each other. In those instances, Dempsey may take a position counter to the market, buying or selling shares to support an orderly market in the affected stocks. In order to perform these obligations, Dempsey holds varying amounts of securities in inventory. In addition, specialists generally may not trade for their own account when public buyers are meeting public sellers in an orderly fashion and may not compete with public orders at the same price. By having to support an orderly market, maintain inventory positions and refrain from trading under some favorable conditions, Dempsey is subject to a high degree of risk. Additionally, stock exchanges periodically amend their rules and may make the rules governing Dempsey's activities as a specialist more stringent or may implement other changes, which could adversely affect its trading revenues.

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 June 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 deemed 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

If we were deemed to solicit orders from our customers or make investment recommendations, 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.

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 will 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 required us to modify the text and the form of presentation of our privacy policies and will require us to incur additional expense to ensure ongoing compliance with the regulations. The enactment or adoption of additional federal and state laws and regulations aimed at protecting consumers' privacy may impose additional compliance costs on us and may further restrict our ability to share customer information with our affiliates and business partners.

In addition, several recent reports have focused attention on the online brokerage industry. 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 powers over ETFC and us, including the ability to issue cease-and-desist orders, force divestiture of the Bank and impose civil money penalties for violations of federal banking laws and regulations or for unsafe or unsound banking practices. 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 record keeping 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 yet 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. Acquisitions of and mergers with other financial institutions, purchases of deposits and loan portfolios, the establishment of new Bank subsidiaries and the commencement of new activities by Bank subsidiaries require the prior approval of the OTS. These regulations and conditions could place us at a competitive disadvantage in an environment in which consolidation within the financial services industry is prevalent. Also, these regulations and conditions could affect our ability to realize synergies from future acquisitions, 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 was 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 and the volume of our loan originations,
- 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 incurred operating losses in prior periods and we may incur operating losses in the future. We reported net losses of $276.0 million for the three months ended March 31, 2002, which includes an extraordinary gain on extinguishment of debt of $4.1 million and a cumulative effect of accounting change of $(299.4) million, net loss of $241.5 million in fiscal 2001, which includes facility restructuring and other nonrecurring changes of $202.8 million, net income of $19.2 million in fiscal 2000 and net loss of $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 achieved in future periods.

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 acquired them

From January 1, 2001 through March 31, 2002, the price per share of our common stock has ranged from a high of $15.38 to a low of $4.07. 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,
- large block transactions in our common stock by institutional investors,
- changes in investor sentiment,
- 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, reduce our access to capital and otherwise harm aspects of 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 wealth management 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 Wealth Management and Other

Our domestic retail brokerage, global and institutional, and wealth management 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 March 31, 2002, we had a variable rate bank line of credit, three variable rate term loans and one installment purchase contract. As of March 31, 2002, we had no borrowings outstanding under this line of credit and $12.8 million outstanding under these term and installment purchase contract. 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 March 31, 2002, the interest payments would increase by an immaterial amount.

Foreign Currency Exchange Risk

A portion of our operations consists 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 adversely affected 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.

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

Our banking operations acquire and manage interest-bearing assets and liabilities in the normal course of business. Interest-bearing instruments include investment securities, loans, deposits, borrowings and derivative financial instruments. As interest-bearing, these instruments are subject to changes in market value as interest rates change. Market risk is the potential for adverse decline in market values. The market values of bank instruments have a direct or indirect impact on Bank earnings, equity and various regulatory constraints.

Interest Rate Risk

The acquisition, maintenance, and disposition of assets and liabilities are critical elements of the Bank's operations. Throughout the process these instruments are subject to market risk, which is the potential for adverse declines in market values. There are numerous factors that may influence the speed and direction of changes in market value including, but not limited to, liquidity, the absolute level of interest rates, the shape of the yield curve and the implied volatility of future interest rate movements. The net market values of bank instruments may direct or indirectly impact the Bank's current or future earnings and is also subject to certain regulatory constraints.

Our Board of Directors delegates responsibility for the day-to-day management of market risk to the Bank's Asset Liability Management Committee. The Asset Liability Management Committee is responsible for measuring, managing and reporting the Bank's aggregate market risk within the policy guidelines and limits established by the Board of Directors. The Bank maintains a Risk Management Group which is independent of the Bank's portfolio management functions to assist the Asset Liability Management Committee in its responsibilities of measuring and managing market risk.

The market risk profile of the Bank is a net result of the combination of all interest-sensitive assets, liabilities and derivatives. At March 31, 2002, approximately 72% of the market value of the Bank's total assets were comprised of residential mortgages and mortgaged-backed securities. The values of these assets are sensitive to changes in interest rates as well as expected prepayment levels. The Bank's liability structure consists primarily of transactional deposit relationships such as money market accounts, shorter-term certificates of deposit and wholesale collateralized borrowings. The derivative portfolio of the Bank is positioned to decrease the overall market risk resulting from the combination of assets and liabilities. The Bank's market risk is discussed and quantified in more detail in the Scenario Analysis section below.

Most of the Bank's assets are generally classified as non-trading portfolios and, as such, are not marked-to-market through earnings for accounting purposes. The Bank did maintain a trading portfolio of investment-grade securities throughout the first quarter of 2002. The market value of the trading portfolio at March 31, 2002 was $169.2 million. The trading portfolio at March 31, 2002 was predominantly investment-grade collateralized mortgage obligations and agency mortgage-backed securities.

Scenario Analysis

Scenario analysis is a more advanced approach to estimating interest rate risk exposure. Under the Net Present Value of Equity ("NPVE") approach, the present value of all existing assets, liabilities, derivatives and forward commitment are estimated and then combined to produce a Net Present Value of Equity figure. The sensitivity of this value to changes in interest rates is then determined by applying alternative interest rate scenarios, which include, but are not limited to, instantaneous parallel shifts up and down of 100, 200 and 300 basis points. The sensitivity of NPVE as of March 31, 2002 and December 31, 2001 and the limits established by the Board of Directors are listed below:

Parallel Change in Interest Rates (bps)	Change in NPVE As of March 31, 2002	Change in NPVE As of December 31, 2001	Board Limit
+300	-27%	-13%	-55%
+200	-20%	-11%	-30%
+100	-11%	- 6%	-15%
Base Case	—	—	—
-100	6%	3%	-15%
-200	- 1%	- 7%	-30%
-300	-14%	-29%	-55%

As of March 31, 2002, the Bank's overall interest rate risk exposure would be classified as "minimal" under the criteria published by the Bank's regulator, the Office of Thrift Supervision.

PART II. OTHER INFORMATION

Item 1. Legal and Administrative Proceedings

In the ordinary course of its business, E*TRADE Securities engaged in certain stock loan transactions with MJK Clearing, Inc., referred to in this Form 10-Q as MJK, involving the lending of Nasdaq-listed common stock of GenesisIntermedia, Inc. referred to in this Form 10-Q as GENI, and other securities from MJK to E*TRADE Securities. Subsequently, E*TRADE Securities redelivered the GENI and/or other securities received from MJK to three other broker-dealers, Wedbush Morgan Securities, referred to in this Form 10-Q as Wedbush, Nomura Securities, Inc., referred to in this Form 10-Q as Nomura, and Fiserv Securities, Inc., referred to in this Form 10-Q as Fiserv. On September 25, 2001, Nasdaq halted trading in the stock of GENI, which had last traded at a price of $5.90 before the halt. As a result, MJK was unable to meet its collateral requirements on the GENI and other securities with certain counterparties to those transactions. MJK was ordered to cease operations by the SEC because it failed to meet regulatory capital requirements, and was placed into SIPC liquidation in the District of Minnesota. These events have led to disputes among several of the participants in the stock loan transactions involving the stock of GENI and other securities lent by MJK regarding which entities should bear the losses resulting from MJK's insolvency. Wedbush, Nomura and Fiserv have commenced separate legal actions against E*TRADE Securities. On or about October 1, 2001, Wedbush filed an action in the Superior Court of the State of California, Los Angeles County, Case No. BC258931. On or about October 21, 2001, Nomura filed an action against E*TRADE Securities in the United States District Court for the Southern District of New York, Case No. 01-CV-9270 (AGS). In addition, on or about October 4, 2001, Fiserv filed an action against E*TRADE Securities in the United States District Court for the Eastern District of Pennsylvania, Case No. CTV-01-5045. These actions seek various forms of equitable relief and seek repayment of a total of approximately $60.0 million received by E*TRADE Securities in connection with the GENI and other stock loan transactions. We take the position that the plaintiffs must look to MJK as the debtor for repayment, and that we have defenses in each of these actions and will vigorously defend ourselves in all matters. To date, E*TRADE Securities has successfully defeated all actions for interim relief or has entered into consent orders essentially maintaining the status quo between the parties until the matter can be judicially resolved. At this time, E*TRADE Securities is unable to predict the ultimate outcome or the amount of any potential losses.

By a Complaint dated December 28, 2001, Thomas Barry, a shareholder, filed a shareholder derivative action on his own behalf and purportedly on behalf of E*TRADE Group, Inc. itself as a Nominal Defendant, against Christos M. Cotsakos, the Company's Chairman of the Board and Chief Executive Officer, and each current member of the Company's Board of Directors, as individuals, in the Superior Court of the State of California, County of San Mateo. Before defendants were obligated to answer this complaint, Mr. Barry filed a "First Amended Shareholder Derivative Complaint" on or about February 26, 2002, for breach of fiduciary duties, waste of corporate assets, abuse of control, and gross mismanagement for acts including, but not limited to, the Board's cancellation and settlement of a $15.0 million loan to Mr. Cotsakos in exchange for his waiver of certain monetary and other rights under his employment agreement; the Board's agreeing as part and parcel of the cancellation and settlement of the foregoing loan to make an additional payment to Mr. Cotsakos of $15.2 million to compensate him for tax liabilities resulting from the cancellation and settlement of the foregoing loan; the Board's approval of other loans to officers and directors, including a $15.0 million loan to founder and director William Porter; and the Company's alleged failure to make full and adequate disclosures about such events in the Company's previous regulatory filings. Mr. Barry seeks damages allegedly sustained by the Company as a result of defendants' alleged acts, as well as his attorney's fees and costs, against all defendants except the Company. On or about April 30, 2002, demurrers (motions to dismiss) to Mr. Barry's First Amended Shareholder Derivative Complaint were filed on behalf of nominal defendant E*TRADE Group, Inc., and the individually-named members of the Company's Board of Directors, contending, among other things, that the Court must dismiss Mr. Barry's complaint because he failed to satisfy his legal obligation to raise his concerns with the Company's Board of Directors before commencing legal action. At this time, we are unable to predict the ultimate outcome of this proceeding.

We believe the foregoing claims against the Company are without merit and intend to defend against them vigorously. An unfavorable outcome in any matters which are not covered by insurance could have a material adverse effect on our business, financial condition and results of operations. In addition, even if the ultimate outcomes are resolved in our favor, the defense of such litigation could entail considerable cost and the diversion of the efforts of management, either of which could have a material adverse effect on our results of operation.

From time to time, we have been threatened with, or named as a defendant in, lawsuits, arbitrations and administrative claims involving securities, banking and other matters. We are also subject to periodic regulatory audits and inspections. Compliance and trading problems that are reported to regulators such as the SEC, the NASDR or the OTS by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal 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 have a material adverse effect on our business, financial condition and results of operations. 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.

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, for the year ended December 31, 2001.

We maintain insurance coverage in such amounts and with such coverages, deductibles and policy limits as management believes are reasonable and prudent. The principal insurance coverage we maintain covers comprehensive general liability, commercial property damage, hardware/software damage, directors and officers, certain criminal acts against the Company and errors and omissions. We believe that such insurance coverage is adequate for the purpose of our business. Our ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the market place, and world events, including the terrorist attacks of September 11, 2001, may impair our ability to obtain insurance in the future.

Item 2. Changes in Securities and Use of Proceeds

In February 2002, holders of aggregate principal amount of $28,710,000 of our 6% convertible notes agreed to exchange such notes for an aggregate of 2,796,675 shares of common stock in exchanges exempt from registration pursuant to Section 3(a)(9) of the Securities Act of 1933.

In March 2002, holders of aggregate principal amount of $21,210,000 of our 6% convertible notes agreed to exchange such notes for an aggregate of 1,923,215 shares of common stock in exchanges exempt from registration pursuant to Section 3(a)(9) of the Securities Act of 1933.

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*

*10.1	Amended and Restated 1996 Incentive Stock Plan
10.2	Form of Employment Agreement dated May 15, 2002, between E*TRADE Group, Inc. and Christos M. Cotsakos (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed May 10, 2002).

(b) *Reports on Form 8-K*

On May 10, 2002, the Company filed a Current Report on Form 8-K to report the announcement of an agreement with Chairman of the Board and Chief Executive Officer Christos M. Cotsakos for a two-year employment contract.

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* Filed herewith.

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: May 15, 2002

By /s/ CHRISTOS M. COTSAKOS

Christos M. Cotsakos
Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)

By /s/ LEONARD C. PURKIS

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

EXHIBIT 10.1

E*TRADE GROUP, INC.
1996 STOCK INCENTIVE PLAN

AS AMENDED AND RESTATED THROUGH APRIL 4, 2002

ARTICLE ONE

GENERAL PROVISIONS

All share numbers in this document reflect the 2-for-1 stock splits effected on January 29, 1999 and May 21, 1999.

I. PURPOSE OF THE PLAN

This 1996 Stock Incentive Plan is intended to promote the interests of E*TRADE Group, Inc., a Delaware corporation, by providing eligible persons with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in the Corporation as an incentive for them to remain in the service of the Corporation.

Capitalized terms shall have the meanings assigned to such terms in the attached Appendix.

II. STRUCTURE OF THE PLAN

A. The Plan shall be divided into five separate equity programs:

— the Discretionary Option Grant Program under which eligible persons may, at the discretion of the Plan Administrator, be granted options to purchase shares of Common Stock,

— the Salary Investment Option Grant Program under which eligible associates may elect to have a portion of their base salary invested each year in special option grants,

— the Stock Issuance Program under which eligible persons may, at the discretion of the Plan Administrator, be issued shares of Common Stock directly, either through the immediate purchase of such shares or as a bonus for services rendered the Corporation (or any Parent or Subsidiary),

— the Automatic Option Grant Program under which eligible non-associate Board members shall automatically receive option grants at periodic intervals to purchase shares of Common Stock, and

— the Director Fee Option Grant Program under which non-associate Board members may elect to have all or any portion of their annual retainer fee otherwise payable in cash applied to a special option grant.

B. The provisions of Articles One and Seven shall apply to all equity programs under the Plan and shall govern the interests of all persons under the Plan.

III. ADMINISTRATION OF THE PLAN

A. The Primary Committee shall have sole and exclusive authority to administer the Discretionary Option Grant and Stock Issuance Programs with respect to Section 16 Insiders. Administration of the Discretionary Option Grant and Stock Issuance Programs with respect to all other persons eligible to participate in those programs may, at the Board's discretion, be vested in the Primary Committee or a Secondary Committee, or the Board may retain the power to administer those programs with respect to all such persons. The members of the Secondary Committee may be Board members who are Associates eligible to receive discretionary option grants or direct stock issuances under the Plan or any other stock option, stock appreciation, stock bonus or other stock plan of the Corporation (or any Parent or Subsidiary).

B. Members of the Primary Committee or any Secondary Committee shall serve for such period of time as the Board may determine and may be removed by the Board at any time. The Board may also at any time terminate the functions of any Secondary Committee and reassume all powers and authority previously delegated to such committee.

C. Each Plan Administrator shall, within the scope of its administrative functions under the Plan, have full power and authority (subject to the provisions of the Plan) to establish such rules and regulations as it may deem appropriate for proper administration of the Discretionary Option Grant and Stock Issuance Programs and to make such determinations under, and issue such interpretations of, the provisions of such programs and any outstanding options or stock issuances thereunder as it may deem necessary or advisable. Decisions of the Plan Administrator within the scope of its administrative functions under the Plan shall be final and binding on all parties who have an interest in the Discretionary Option Grant and Stock Issuance Programs under its jurisdiction or any option or stock issuance thereunder.

D. The Primary Committee shall have the sole and exclusive authority to determine which Section 16 Insiders and other highly compensated Associates shall be eligible for participation in the Salary Investment Option Grant Program for one or more calendar years. However, all option grants under the Salary Investment Option Grant Program shall be made in accordance with the express terms of that program, and the Primary Committee shall not exercise any discretionary functions with respect to the option grants made under that program.

E. Service on the Primary Committee or the Secondary Committee shall constitute service as a Board member, and members of each such committee shall accordingly be entitled to full indemnification and reimbursement as Board members for their service on such committee. No member of the Primary Committee or the Secondary Committee shall be liable for any act or omission made in good faith with respect to the Plan or any option grants or stock issuances under the Plan.

F. Administration of the Automatic Option Grant and Director Fee Option Grant Programs shall be self-executing in accordance with the terms of those programs, and no Plan Administrator shall exercise any discretionary functions with respect to any option grants or stock issuances made under those programs.

IV. ELIGIBILITY

A. The persons eligible to participate in the Discretionary Option Grant and Stock Issuance Programs are as follows:

1. Associates,

2. non-associate members of the Board or the board of directors of any Parent or Subsidiary, and

3. consultants and other independent advisors who provide services to the Corporation (or any Parent or Subsidiary).

B. Only Employees who are Section 16 Insiders or other highly compensated individuals shall be eligible to participate in the Salary Investment Option Grant Program.

C. Each Plan Administrator shall, within the scope of its administrative jurisdiction under the Plan, have full authority to determine, (i) with respect to the option grants under the Discretionary Option Grant Program, which eligible persons are to receive option grants, the time or times when such option grants are to be made, the number of shares to be covered by each such grant, the status of the granted option as either an Incentive Option or a Non-Statutory Option, the time or times when each option is to become exercisable, the vesting schedule (if any) applicable to the option shares and the maximum term for which the option is to remain outstanding and (ii) with respect to stock issuances under the Stock Issuance Program, which eligible persons are to receive stock issuances, the time or times when such issuances are to be made, the number of shares to be issued to each Participant, the vesting schedule (if any) applicable to the issued shares and the consideration for such shares.

D. The Plan Administrator shall have the absolute discretion either to grant options in accordance with the Discretionary Option Grant Program or to effect stock issuances in accordance with the Stock Issuance Program.

E. The individuals who shall be eligible to participate in the Automatic Option Grant Program shall be limited to (i) those individuals serving as non-associate Board members on the Underwriting Date who have not previously received a stock option grant from the Corporation, (ii) those individuals who first become non-associate Board members after the Underwriting Date, whether through appointment by the Board or election by the Corporation's stockholders, and (iii) those individuals who continue to serve as non-associate Board members at one or more Annual Stockholders Meetings held after the Underwriting Date. A non-associate Board member who has previously been in the employ of the Corporation (or any Parent or Subsidiary) shall not be eligible to receive an option grant under the Automatic Option Grant Program at the time he or she first becomes a non-associate Board member, but shall be eligible to receive periodic option grants under the Automatic Option Grant Program while he or she continues to serve as a non-associate Board member.

F. All non-associate Board members shall be eligible to participate in the Director Fee Option Grant Program.

V. STOCK SUBJECT TO THE PLAN

A. The stock issuable under the Plan shall be shares of authorized but unissued or reacquired Common Stock, including shares repurchased by the Corporation on the open market. The maximum number of shares of Common Stock initially reserved for issuance over the term of the Plan shall not exceed 102,779,616 shares, except as adjusted from time to time as set forth in Section V(B) below. Such authorized share reserve is comprised of (i) the shares subject to the outstanding options under the Predecessor Plan which have been incorporated into the Plan plus (ii) an additional increase of 16,000,000 shares authorized by the Board and subsequently approved by the stockholders prior to the Section 12 Registration Date, plus (iii) an additional increase of 7,600,000 shares authorized by the Board on December 22, 1997, and approved by the stockholders at the 1998 Annual Meeting; plus (iv) an additional increase of 11,000,000 shares authorized by the Board on October 21, 1998, and approved by the stockholders at the 1999 Annual Meeting; plus (v) an additional increase of 11,900,000 shares authorized by the Board and approved by the stockholders on December 21, 1999; plus (vi) an additional increase of 14,923,512 shares authorized by the Board on October 25, 2000 and approved by the stockholders at the 2000 Annual Meeting, plus (vii) an additional increase of 17,379,624 shares pursuant to the automatic increase effected on January 2, 2002.

B. The number of shares of Common Stock available for issuance under the Plan shall automatically increase, on the first trading day of January of each calendar year in the four (4) calendar-year period beginning with the 2002 calendar year and continuing through the share increase effected for calendar year 2005, by an amount equal to five percent (5%) of the total number of shares of Common Stock outstanding on the last trading day in December of the immediately preceding calendar year.

C. No one person participating in the Plan may receive options, separately exercisable stock appreciation rights and direct stock issuances for more than 6,000,000 shares of Common Stock in the aggregate per calendar year.

D. Shares of Common Stock subject to outstanding options (including options incorporated into this Plan from the Predecessor Plan) shall be available for subsequent issuance under the Plan to the extent those options expire or terminate for any reason prior to exercise in full. Unvested shares issued under the Plan and subsequently cancelled or repurchased by the Corporation, at the original issue price paid per share, pursuant to the Corporation's repurchase rights under the Plan shall be added back to the number of shares of

Common Stock reserved for issuance under the Plan and shall accordingly be available for reissuance through one or more subsequent option grants or direct stock issuances under the Plan. However, should the exercise price of an option under the Plan be paid with shares of Common Stock or should shares of Common Stock otherwise issuable under the Plan be withheld by the Corporation in satisfaction of the withholding taxes incurred in connection with the exercise of an option or the vesting of a stock issuance under the Plan, then the number of shares of Common Stock available for issuance under the Plan shall be reduced by the gross number of shares for which the option is exercised or which vest under the stock issuance, and not by the net number of shares of Common Stock issued to the holder of such option or stock issuance.

E. If any change is made to the Common Stock by reason of any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration, appropriate adjustments shall be made to (i) the maximum number and/or class of securities issuable under the Plan, (ii) the number and/or class of securities for which any one person may be granted stock options, separately exercisable stock appreciation rights and direct stock issuances under this Plan per calendar year, (iii) the number and/or class of securities for which grants are subsequently to be made under the Automatic Option Grant Program to new and continuing non-associate Board members, (iv) the number and/or class of securities and the exercise price per share in effect under each outstanding option under the Plan and (v) the number and/or class of securities and price per share in effect under each outstanding option incorporated into this Plan from the Predecessor Plan. Such adjustments to the outstanding options are to be effected in a manner which shall preclude the enlargement or dilution of rights and benefits under such options. The adjustments determined by the Plan Administrator shall be final, binding and conclusive.

ARTICLE TWO

DISCRETIONARY OPTION GRANT PROGRAM

I. OPTION TERMS

Each option shall be evidenced by one or more documents in the form approved by the Plan Administrator; provided, however, that each such document shall comply with the terms specified below. Each document evidencing an Incentive Option shall, in addition, be subject to the provisions of the Plan applicable to such options.

A. Exercise Price.

1. The exercise price per share shall be fixed by the Plan Administrator but shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall become immediately due upon exercise of the option and shall, subject to the provisions of Section I of Article Seven and the documents evidencing the option, be payable in one or more of the forms specified below:

(i) cash or check made payable to the Corporation,

(ii) shares of Common Stock held for the requisite period necessary to avoid a charge to the Corporation's earnings for financial reporting purposes and valued at Fair Market Value on the Exercise Date, or

(iii) to the extent the option is exercised for vested shares, through a special sale and remittance procedure pursuant to which the Optionee shall concurrently provide irrevocable written instructions to (a) a Corporation-designated brokerage firm to effect the immediate sale of the purchased shares and remit to the Corporation, out of the sale proceeds available on the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable Federal, state and local income and employment taxes required to be withheld by the Corporation by reason of such exercise and (b) the Corporation to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale.

Except to the extent such sale and remittance procedure is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

B. **Exercise and Term of Options**. Each option shall be exercisable at such time or times, during such period and for such number of shares as shall be determined by the Plan Administrator and set forth in the documents evidencing the option. However, no option shall have a term in excess of ten (10) years measured from the option grant date.

C. **Effect of Termination of Service.**

1. The following provisions shall govern the exercise of any options held by the Optionee at the time of cessation of Service or death:

(i) Any option outstanding at the time of the Optionee's cessation of Service for any reason shall remain exercisable for such period of time thereafter as shall be determined by the Plan Administrator and set forth in the documents evidencing the option, but no such option shall be exercisable after the expiration of the option term.

(ii) Any option exercisable in whole or in part by the Optionee at the time of death may be subsequently exercised by the personal representative of the Optionee's estate or by the person or persons to whom the option is transferred pursuant to the Optionee's will or in accordance with the laws of descent and distribution.

(iii) Should the Optionee's Service be terminated for Misconduct, then all outstanding options held by the Optionee shall terminate immediately and cease to be outstanding.

(iv) During the applicable post-Service exercise period, the option may not be exercised in the aggregate for more than the number of vested shares for which the option is exercisable on the date of the Optionee's cessation of Service. Upon the expiration of the applicable exercise period or (if earlier) upon the expiration of the option term, the option shall terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the Optionee's cessation of Service, terminate and cease to be outstanding to the extent the option is not otherwise at that time exercisable for vested shares.

2. The Plan Administrator shall have complete discretion, exercisable either at the time an option is granted or at any time while the option remains outstanding, to:

(i) extend the period of time for which the option is to remain exercisable following the Optionee's cessation of Service from the limited exercise period otherwise in effect for that option to such greater period of time as the Plan Administrator shall deem appropriate, but in no event beyond the expiration of the option term, and/or

(ii) permit the option to be exercised, during the applicable post-Service exercise period, not only with respect to the number of vested shares of Common Stock for which such option is exercisable at the time of the Optionee's cessation of Service but also with respect to one or more additional installments in which the Optionee would have vested had the Optionee continued in Service.

D. **Stockholder Rights**. The holder of an option shall have no stockholder rights with respect to the shares subject to the option until such person shall have exercised the option, paid the exercise price and become a holder of record of the purchased shares.

E. **Repurchase Rights**. The Plan Administrator shall have the discretion to grant options which are exercisable for unvested shares of Common Stock. Should the Optionee cease Service while holding such unvested shares, the Corporation shall have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms upon which such repurchase right shall be exercisable (including the period and procedure for exercise and the appropriate vesting schedule for the purchased shares) shall be established by the Plan Administrator and set forth in the document evidencing such repurchase right.

F. **Limited Transferability of Options**. During the lifetime of the Optionee, Incentive Options shall be exercisable only by the Optionee and shall not be assignable or transferable other than by will or by the laws of descent and distribution following the Optionee's death. However, a Non-Statutory Option may, in connection with the Optionee's estate plan, be assigned in whole or in part during the Optionee's lifetime to one or more members of the Optionee's immediate family or to a trust established exclusively for one or more such family members. The assigned portion may only be exercised by the person or persons who acquire a proprietary interest in the option pursuant to the assignment. The terms applicable to the assigned portion shall be the same as those in effect for the option immediately prior to such assignment and shall be set forth in such documents issued to the assignee as the Plan Administrator may deem appropriate.

II. INCENTIVE OPTIONS

The terms specified below shall be applicable to all Incentive Options. Except as modified by the provisions of this Section II, all the provisions of Articles One, Two and Seven shall be applicable to Incentive Options. Options which are specifically designated as Non-Statutory Options when issued under the Plan shall not be subject to the terms of this Section II.

A. **Eligibility**. Incentive Options may only be granted to Associates.

B. **Dollar Limitation**. The aggregate Fair Market Value of the shares of Common Stock (determined as of the respective date or dates of grant) for which one or more options granted to any Associate under the Plan (or any other option plan of the Corporation or any Parent or Subsidiary) may for the first time become exercisable as Incentive Options during any one calendar year shall not exceed the sum of One Hundred Thousand Dollars ($100,000). To the extent the Associate holds two (2) or more such options which become exercisable for the first time in the same calendar year, the foregoing limitation on the exercisability of such options as Incentive Options shall be applied on the basis of the order in which such options are granted.

C. <u>10% Stockholder</u>. If any Associate to whom an Incentive Option is granted is a 10% Stockholder, then the exercise price per share shall not be less than one hundred ten percent (110%) of the Fair Market Value per share of Common Stock on the option grant date, and the option term shall not exceed five (5) years measured from the option grant date.

III. CORPORATE TRANSACTION/CHANGE IN CONTROL

A. In the event of any Corporate Transaction, each outstanding option shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Corporate Transaction, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. However, an outstanding option shall not so accelerate if and to the extent: (i) such option is, in connection with the Corporate Transaction, either to be assumed by the successor corporation (or parent thereof) or to be replaced with a comparable option to purchase shares of the capital stock of the successor corporation (or parent thereof), (ii) such option is to be replaced with a cash incentive program of the successor corporation which preserves the spread existing on the unvested option shares at the time of the Corporate Transaction and provides for subsequent payout in accordance with the same vesting schedule applicable to such option or (iii) the acceleration of such option is subject to other limitations imposed by the Plan Administrator at the time of the option grant. The determination of option comparability under clause (i) above shall be made by the Plan Administrator, and its determination shall be final, binding and conclusive.

B. All outstanding repurchase rights shall also terminate automatically, and the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Corporate Transaction, except to the extent: (i) those repurchase rights are to be assigned to the successor corporation (or parent thereof) in connection with such Corporate Transaction or (ii) such accelerated vesting is precluded by other limitations imposed by the Plan Administrator at the time the repurchase right is issued.

C. Immediately following the consummation of the Corporate Transaction, all outstanding options shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof).

D. Each option which is assumed in connection with a Corporate Transaction shall be appropriately adjusted, immediately after such Corporate Transaction, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Corporate Transaction had the option been exercised immediately prior to such Corporate Transaction. Appropriate adjustments to reflect such Corporate Transaction shall also be made to (i) the exercise price payable per share under each outstanding option, <u>provided</u> the aggregate exercise price payable for such securities shall remain the same, (ii) the maximum number and/or class of securities available for issuance over the remaining term of the Plan and (iii) the maximum number and/or class of securities for which any one person may be granted stock options, separately exercisable stock appreciation rights and direct stock issuances under the Plan per calendar year.

E. The Plan Administrator shall have full power and authority to grant options under the Discretionary Option Grant Program which will automatically accelerate in the event the Optionee's Service subsequently terminates by reason of an Involuntary Termination within a designated period (not to exceed eighteen (18) months) following the effective date of any Corporate Transaction in which those options are assumed or replaced and do not otherwise accelerate. Any options so accelerated shall remain exercisable for fully-vested shares until the earlier of (i) the expiration of the option term or (ii) the expiration of the one (1)-year period measured from the effective date of the Involuntary Termination. In addition, the Plan Administrator may provide that one or more of the Corporation's outstanding repurchase rights with respect to shares held by the Optionee at the time of such Involuntary Termination shall immediately terminate, and the shares subject to those terminated repurchase rights shall accordingly vest in full.

F. The Plan Administrator shall have full power and authority to grant options under the Discretionary Option Grant Program which will automatically accelerate in the event the Optionee's Service subsequently terminates by reason of an Involuntary Termination within a designated period (not to exceed eighteen (18) months) following the effective date of any Change in Control. Each option so accelerated shall remain exercisable for fully-vested shares until the earlier of (i) the expiration of the option term or (ii) the expiration of the one (1)-year period measured from the effective date of the Involuntary Termination. In addition, the Plan Administrator may provide that one or more of the Corporation's outstanding repurchase rights with respect to shares held by the Optionee at the time of such Involuntary Termination shall immediately terminate, and the shares subject to those terminated repurchase rights shall accordingly vest in full.

G. The portion of any Incentive Option accelerated in connection with a Corporate Transaction or Change in Control shall remain exercisable as an Incentive Option only to the extent the applicable One Hundred Thousand Dollar limitation is not exceeded. To the extent such dollar limitation is exceeded, the accelerated portion of such option shall be exercisable as a Non-Statutory Option under the Federal tax laws.

H. The outstanding options shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

IV. [Intentionally Deleted]

V. STOCK APPRECIATION RIGHTS

A. The Plan Administrator shall have full power and authority to grant to selected Optionees tandem stock appreciation rights and/or limited stock appreciation rights.

B. The following terms shall govern the grant and exercise of tandem stock appreciation rights:

(i) One or more Optionees may be granted the right, exercisable upon such terms as the Plan Administrator may establish, to elect between the exercise of the underlying option for shares of Common Stock and the surrender of that option in exchange for a distribution from the Corporation in an amount equal to the excess of (a) the Fair Market Value (on the option surrender date) of the number of shares in which the Optionee is at the time vested under the surrendered option (or surrendered portion thereof) over (b) the aggregate exercise price payable for such shares.

(ii) No such option surrender shall be effective unless it is approved by the Plan Administrator. If the surrender is so approved, then the distribution to which the Optionee shall be entitled may be made in shares of Common Stock valued at Fair Market Value on the option surrender date, in cash, or partly in shares and partly in cash, as the Plan Administrator shall in its sole discretion deem appropriate.

(iii) If the surrender of an option is rejected by the Plan Administrator, then the Optionee shall retain whatever rights the Optionee had under the surrendered option (or surrendered portion thereof) on the option surrender date and may exercise such rights at any time prior to the later of (a) five (5) business days after the receipt of the rejection notice or (b) the last day on which the option is otherwise exercisable in accordance with the terms of the documents evidencing such option, but in no event may such rights be exercised more than ten (10) years after the option grant date.

C. The following terms shall govern the grant and exercise of limited stock appreciation rights:

(i) One or more Section 16 Insiders may be granted limited stock appreciation rights with respect to their outstanding options.

(ii) Upon the occurrence of a Hostile Take-Over, each individual holding one or more options with such a limited stock appreciation right shall have the unconditional right (exercisable for a thirty (30)-day period following such Hostile Take-Over) to surrender each such option to the Corporation, to the extent the option is at the time exercisable for vested shares of Common Stock. In return for the surrendered option, the Optionee shall receive a cash distribution from the Corporation in an amount equal to the excess of (A) the Take-Over Price of the shares of Common Stock which are at the time vested under each surrendered option (or surrendered portion thereof) over (B) the aggregate exercise price payable for such shares. Such cash distribution shall be paid within five (5) days following the option surrender date.

(iii) The Plan Administrator shall, at the time the limited stock appreciation right is granted, pre-approve the subsequent exercise of that right in accordance with the terms and conditions of this Section V.C. Accordingly, no additional approval of the Plan Administrator or the Board shall be required at the time of the actual option surrender and cash distribution.

(iv) The balance of the option (if any) shall continue in full force and effect in accordance with the documents evidencing such option.

ARTICLE THREE

SALARY INVESTMENT OPTION GRANT PROGRAM

I. OPTION GRANTS

The Primary Committee shall have the sole and exclusive authority to determine the calendar year or years (if any) for which the Salary Investment Option Grant Program is to be in effect and to select the Section 16 Insiders and other highly compensated Associates eligible to participate in the Salary Investment Option Grant Program for those calendar year or years. Each selected individual who elects to participate in the Salary Investment Option Grant Program must, prior to the start of each calendar year of participation, file with the Plan Administrator (or its designate) an irrevocable authorization directing the Corporation to reduce his or her base salary for that calendar year by an amount not less than Ten Thousand Dollars ($10,000.00) nor more than Two Hundred Thousand Dollars ($200,000.00). The Primary Committee shall have complete discretion to determine whether to approve the filed authorization in whole or in part. To the extent the Primary Committee approves the authorization, the individual who filed that authorization shall automatically be granted an option under the Salary Investment Grant Program on the first trading day in January of the calendar year for which the salary reduction is to be in effect.

II. OPTION TERMS

Each option shall be a Non-Statutory Option evidenced by one or more documents in the form approved by the Plan Administrator; provided, however, that each such document shall comply with the terms specified below.

A. Exercise Price.

1. The exercise price per share shall be thirty-three and one-third percent (33-1/3%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall become immediately due upon exercise of the option and shall be payable in one or more of the alternative forms authorized under the Discretionary Option Grant Program. Except to the extent the sale and remittance procedure specified thereunder is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

B. Number of Option Shares. The number of shares of Common Stock subject to the option shall be determined pursuant to the following formula (rounded down to the nearest whole number):

$X = A \div (B \times 66\text{-}2/3\%)$, where

X is the number of option shares,

A is the dollar amount of the approved reduction in the Optionee's base salary for the calendar year, and

B is the Fair Market Value per share of Common Stock on the option grant date.

C. Exercise and Term of Options. The option shall become exercisable in a series of twelve (12) successive equal monthly installments upon the Optionee's completion of each calendar month of Service in the calendar year for which the salary reduction is in effect. Each option shall have a maximum term of ten (10) years measured from the option grant date.

D. Effect of Termination of Service. Should the Optionee cease Service for any reason while holding one or more options under this Article Three, then each such option shall remain exercisable, for any or all of the shares for which the option is exercisable at the time of such cessation of Service, until the earlier of (i) the expiration of the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of such cessation of Service. Should the Optionee die while holding one or more options under this Article Three, then each such option may be exercised, for any or all of the shares for which the option is exercisable at the time of the Optionee's cessation of Service (less any shares subsequently purchased by Optionee prior to death), by the personal representative of the Optionee's estate or by the person or persons to whom the option is transferred pursuant to the Optionee's will or in accordance with the laws of descent and distribution. Such right of exercise shall lapse, and the option shall terminate, upon the earlier of (i) the expiration of the ten (10)-year option term or (ii) the three (3)-year period measured from the date of the Optionee's cessation of Service. However, the option shall, immediately upon the Optionee's cessation of Service for any reason, terminate and cease to remain outstanding with respect to any and all shares of Common Stock for which the option is not otherwise at that time exercisable.

III. CORPORATE TRANSACTION/CHANGE IN CONTROL/HOSTILE TAKE-OVER

A. In the event of any Corporate Transaction while the Optionee remains in Service, each outstanding option held by such Optionee under this Salary Investment Option Grant Program shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Corporate Transaction, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. Each such outstanding option shall be assumed by the successor corporation (or parent thereof) in the Corporate Transaction and shall remain exercisable for the fully-vested shares until the earlier of (i) the expiration of the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of the Optionee's cessation of Service.

B. In the event of a Change in Control while the Optionee remains in Service, each outstanding option held by such Optionee under this Salary Investment Option Grant Program shall automatically accelerate so that each such option shall immediately become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. The option shall remain so exercisable until the earlier of (i) the expiration of the ten (10)-year option term, (ii) the expiration of the three (3)-year period measured from the date of the Optionee's cessation of Service or (iii) the surrender of the option in connection with a Hostile Take-Over.

C. Upon the occurrence of a Hostile Take-Over, the Optionee shall have a thirty (30)-day period in which to surrender to the Corporation each outstanding option granted him or her under the Salary Investment Option Grant Program. The Optionee shall in return be entitled to a cash distribution from the Corporation in an amount equal to the excess of (i) the Take-Over Price of the shares of Common Stock at the time subject to the surrendered option (whether or not the Optionee is otherwise at the time vested in those shares) over (ii) the aggregate exercise price payable for such shares. Such cash distribution shall be paid within five (5) days following the surrender of the option to the Corporation. The Primary Committee shall, at the time the option with such limited stock appreciation right is granted under the Salary Investment Option Grant Program, pre-approve any subsequent exercise of that right in accordance with the terms of this Paragraph C. Accordingly, no further approval of the Primary Committee or the Board shall be required at the time of the actual option surrender and cash distribution.

D. The grant of options under the Salary Investment Option Grant Program shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

IV. REMAINING TERMS

The remaining terms of each option granted under the Salary Investment Option Grant Program shall be the same as the terms in effect for option grants made under the Discretionary Option Grant Program.

ARTICLE FOUR

STOCK ISSUANCE PROGRAM

I. STOCK ISSUANCE TERMS

Shares of Common Stock may be issued under the Stock Issuance Program through direct and immediate issuances without any intervening option grants. Each such stock issuance shall be evidenced by a Stock Issuance Agreement which complies with the terms specified below.

A. Purchase Price.

1. The purchase price per share shall be fixed by the Plan Administrator, but shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the issuance date.

2. Subject to the provisions of Section I of Article Seven, shares of Common Stock may be issued under the Stock Issuance Program for any of the following items of consideration which the Plan Administrator may deem appropriate in each individual instance:

(i) cash or check made payable to the Corporation, or

(ii) past services rendered to the Corporation (or any Parent or Subsidiary).

B. Vesting Provisions.

1. Shares of Common Stock issued under the Stock Issuance Program may, in the discretion of the Plan Administrator, be fully and immediately vested upon issuance or may vest in one or more installments over the Participant's period of Service or upon attainment of specified performance objectives. The elements of the vesting schedule applicable to any unvested shares of Common Stock issued under the Stock Issuance Program, namely:

(i) the Service period to be completed by the Participant or the performance objectives to be attained,

(ii) the number of installments in which the shares are to vest,

(iii) the interval or intervals (if any) which are to lapse between installments, and

(iv) the effect which death, Permanent Disability or other event designated by the Plan Administrator is to have upon the vesting schedule, shall be determined by the Plan Administrator and incorporated into the Stock Issuance Agreement.

2. Any new, substituted or additional securities or other property (including money paid other than as a regular cash dividend) which the Participant may have the right to receive with respect to the Participant's unvested shares of Common Stock by reason of any stock dividend, stock split, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration shall be issued subject to (i) the same vesting requirements applicable to the Participant's unvested shares of Common Stock and (ii) such escrow arrangements as the Plan Administrator shall deem appropriate.

3. The Participant shall have full stockholder rights with respect to any shares of Common Stock issued to the Participant under the Stock Issuance Program, whether or not the Participant's interest in those shares is vested. Accordingly, the Participant shall have the right to vote such shares and to receive any regular cash dividends paid on such shares.

4. Should the Participant cease to remain in Service while holding one or more unvested shares of Common Stock issued under the Stock Issuance Program or should the performance objectives not be attained with respect to one or more such unvested shares of Common Stock, then those shares shall be immediately surrendered to the Corporation for cancellation, and the Participant shall have no further stockholder rights with respect to those shares. To the extent the surrendered shares were previously issued to the Participant for consideration paid in cash or cash equivalent (including the Participant's purchase-money indebtedness), the Corporation shall repay to the Participant the cash consideration paid for the surrendered shares and shall cancel the unpaid principal balance of any outstanding purchase-money note of the Participant attributable to the surrendered shares.

5. The Plan Administrator may in its discretion waive the surrender and cancellation of one or more unvested shares of Common Stock (or other assets attributable thereto) which would otherwise occur upon the cessation of the Participant's Service or the non-attainment of the performance objectives applicable to those shares. Such waiver shall result in the immediate vesting of the Participant's interest in the shares of Common Stock as to which the waiver applies. Such waiver may be effected at any time, whether before or after the Participant's cessation of Service or the attainment or non-attainment of the applicable performance objectives.

II. CORPORATE TRANSACTION/CHANGE IN CONTROL

A. All of the Corporation's outstanding repurchase/cancellation rights under the Stock Issuance Program shall terminate automatically, and all the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Corporate Transaction, except to the extent (i) those repurchase/cancellation rights are to be assigned to the successor corporation (or parent thereof) in connection with such Corporate Transaction or (ii) such accelerated vesting is precluded by other limitations imposed in the Stock Issuance Agreement.

B. The Plan Administrator shall have the discretionary authority, exercisable either at the time the unvested shares are issued or any time while the Corporation's repurchase/cancellation rights remain outstanding under the Stock Issuance Program, to provide that those rights shall automatically terminate in whole or in part, and the shares of Common Stock subject to those terminated rights shall immediately vest, in the event the Participant's Service should subsequently terminate by reason of an Involuntary Termination within a designated period (not to exceed eighteen (18) months) following the effective date of any Corporate Transaction in which those repurchase/cancellation rights are assigned to the successor corporation (or parent thereof).

C. The Plan Administrator shall have the discretionary authority, exercisable either at the time the unvested shares are issued or any time while the Corporation's repurchase/cancellation rights remain outstanding under the Stock Issuance Program, to provide that those rights shall automatically terminate in whole or in part, and the shares of Common Stock subject to those terminated rights shall immediately vest, in the event the Participant's Service should subsequently terminate by reason of an Involuntary Termination within a designated period (not to exceed eighteen (18) months) following the effective date of any Change in Control.

III SHARE ESCROW/LEGENDS

Unvested shares may, in the Plan Administrator's discretion, be held in escrow by the Corporation until the Participant's interest in such shares vests or may be issued directly to the Participant with restrictive legends on the certificates evidencing those unvested shares.

ARTICLE FIVE

AUTOMATIC OPTION GRANT PROGRAM

I. OPTION TERMS

A. Grant Dates. Option grants shall be made on the dates specified below:

1. Each individual serving as a non-associate Board member on the Underwriting Date shall automatically be granted at that time a Non-Statutory Option to purchase 80,000 shares of Common Stock, provided that individual has not previously been in the employ of the Corporation or any Parent or Subsidiary and has not previously received a stock option grant from the Corporation.

2. Each individual who is first elected or appointed as a non-associate Board member at any time after the Underwriting Date until April 19, 2000 shall automatically be granted, on the date of such initial election or appointment, a Non-Statutory Option to purchase 80,000 shares of Common Stock, provided that individual has not previously been in the employ of the Corporation or any Parent or Subsidiary.

3. Each individual who is first elected or appointed as a non-associate Board member at any time after April 19, 2000 shall automatically be granted, on the date of such initial election or appointment, a Non-Statutory Option to purchase 50,000 shares of Common Stock, provided that individual has not previously been in the employ of the Corporation or any Parent or Subsidiary.

4. On the date of each Annual Stockholders Meeting held after the Underwriting Date, each individual who is to continue to serve as an Eligible Director, whether or not that individual is standing for re-election to the Board at that particular Annual Meeting, shall automatically be granted a Non-Statutory Option to purchase 20,000 shares of Common Stock, provided such individual has served as a non-associate Board member for at least six (6) months. There shall be no limit on the number of such 20,000 share option grants any one Eligible Director may receive over his or her period of Board service, and non-associate Board members who have previously been in the employ of the Corporation (or any Parent or Subsidiary) or who have otherwise received a stock option grant from the Corporation prior to the Underwriting Date shall be eligible to receive one or more such annual option grants over their period of continued Board service.

B. Exercise Price.

1. The exercise price per share shall be equal to one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall be payable in one or more of the alternative forms authorized under the Discretionary Option Grant Program. Except to the extent

the sale and remittance procedure specified thereunder is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

C. **Option Term.** Each option shall have a term of ten (10) years measured from the option grant date.

D. **Exercise and Vesting of Options.** Each option shall be immediately exercisable for any or all of the option shares. However, any shares purchased under the option shall be subject to repurchase by the Corporation, at the exercise price paid per share, upon the Optionee's cessation of Board service prior to vesting in those shares. Each initial 50,000-share or 80,000-share grant (as applicable, in accordance with the provisions of Sections I.A.2 and I.A.3 of this Article Five) shall vest, and the Corporation's repurchase right shall lapse, in a series of four (4) successive equal annual installments over the Optionee's period of continued service as a Board member, with the first such installment to vest upon the Optionee's completion of one (1) year of Board service measured from the option grant date. Each annual 20,000-share grant shall vest, and the Corporation's repurchase right shall lapse, upon the Optionee's completion of two (2) years of Board service measured from the option grant date.

E. **Termination of Board Service.** The following provisions shall govern the exercise of any options held by the Optionee at the time the Optionee ceases to serve as a Board member:

(i) The Optionee (or, in the event of Optionee's death, the personal representative of the Optionee's estate or the person or persons to whom the option is transferred pursuant to the Optionee's will or in accordance with the laws of descent and distribution) shall have a twelve (12)-month period following the date of such cessation of Board service in which to exercise each such option.

(ii) During the twelve (12)-month exercise period, the option may not be exercised in the aggregate for more than the number of vested shares of Common Stock for which the option is exercisable at the time of the Optionee's cessation of Board service.

(iii) Should the Optionee cease to serve as a Board member by reason of death or Permanent Disability, then all shares at the time subject to the option shall immediately vest so that such option may, during the twelve (12)-month exercise period following such cessation of Board service, be exercised for all or any portion of those shares as fully-vested shares of Common Stock.

(iv) In no event shall the option remain exercisable after the expiration of the option term. Upon the expiration of the twelve (12)-month exercise period or (if earlier) upon the expiration of the option term, the option shall terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the

Optionee's cessation of Board service for any reason other than death or Permanent Disability, terminate and cease to be outstanding to the extent the option is not otherwise at that time exercisable for vested shares.

II. CORPORATE TRANSACTION/CHANGE IN CONTROL/ HOSTILE TAKE-OVER

A. In the event of any Corporate Transaction, the shares of Common Stock at the time subject to each outstanding option but not otherwise vested shall automatically vest in full so that each such option shall, immediately prior to the effective date of the Corporate Transaction, become fully exercisable for all of the shares of Common Stock at the time subject to such option and may be exercised for all or any portion of those shares as fully-vested shares of Common Stock. Immediately following the consummation of the Corporate Transaction, each automatic option grant shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof).

B. In connection with any Change in Control, the shares of Common Stock at the time subject to each outstanding option but not otherwise vested shall automatically vest in full so that each such option shall, immediately prior to the effective date of the Change in Control, become fully exercisable for all of the shares of Common Stock at the time subject to such option and may be exercised for all or any portion of those shares as fully-vested shares of Common Stock. Each such option shall remain exercisable for such fully-vested option shares until the expiration or sooner termination of the option term or the surrender of the option in connection with a Hostile Take-Over.

C. Upon the occurrence of a Hostile Take-Over, the Optionee shall have a thirty (30)-day period in which to surrender to the Corporation each automatic option held by him or her. The Optionee shall in return be entitled to a cash distribution from the Corporation in an amount equal to the excess of (i) the Take-Over Price of the shares of Common Stock at the time subject to the surrendered option (whether or not the Optionee is otherwise at the time vested in those shares) over (ii) the aggregate exercise price payable for such shares. Such cash distribution shall be paid within five (5) days following the surrender of the option to the Corporation. Stockholder approval of the Plan, as amended and restated on December 24, 1998, shall constitute pre-approval of the surrender of each automatic option in accordance with the terms and provisions of this Section II.C. No additional approval of any Plan Administrator or the consent of the Board shall be required in connection with such option surrender and cash distribution.

D. Each option which is assumed in connection with a Corporate Transaction shall be appropriately adjusted, immediately after such Corporate Transaction, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Corporate Transaction had the option been exercised immediately prior to such Corporate Transaction. Appropriate adjustments shall also be made to the exercise price payable per share under each outstanding option, provided the aggregate exercise price payable for such securities shall remain the same.

E. The grant of options under the Automatic Option Grant Program shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

III. REMAINING TERMS

The remaining terms of each option granted under the Automatic Option Grant Program shall be the same as the terms in effect for option grants made under the Discretionary Option Grant Program.

ARTICLE SIX

DIRECTOR FEE OPTION GRANT PROGRAM

I. OPTION GRANTS

Each non-associate Board member may elect to apply all or any portion of the annual retainer fee otherwise payable in cash for his or her service on the Board to the acquisition of a special option grant under this Director Fee Option Grant Program. Such election must be filed with the Corporation's Chief Financial Officer prior to first day of the calendar year for which the annual retainer fee which is the subject of that election is otherwise payable. Each non-associate Board member who files such a timely election shall automatically be granted an option under this Director Fee Option Grant Program on the first trading day in January in the calendar year for which the annual retainer fee which is the subject of that election would otherwise be payable in cash.

II. OPTION TERMS

Each option shall be a Non-Statutory Option governed by the terms and conditions specified below.

A. Exercise Price.

1. The exercise price per share shall be thirty-three and one-third percent (33-1/3%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall become immediately due upon exercise of the option and shall be payable in one or more of the alternative forms authorized under the Discretionary Option Grant Program. Except to the extent the sale and remittance procedure specified thereunder is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

B. Number of Option Shares. The number of shares of Common Stock subject to the option shall be determined pursuant to the following formula (rounded down to the nearest whole number):

X = A ÷ (B x 66-2/3%), where

X is the number of option shares,

A is the portion of the annual retainer fee subject to the non-associate Board member's election, and

B is the Fair Market Value per share of Common Stock on the option grant date.

C. **Exercise and Term of Options.** The option shall become exercisable in a series of twelve (12) equal monthly installments upon the Optionee's completion of each month of Board service over the twelve (12)-month period measured from the grant date. Each option shall have a maximum term of ten (10) years measured from the option grant date.

D. **Termination of Board Service.** Should the Optionee cease Board service for any reason (other than death or Permanent Disability) while holding one or more options under this Director Fee Option Grant Program, then each such option shall remain exercisable, for any or all of the shares for which the option is exercisable at the time of such cessation of Board service, until the earlier of (i) the expiration of the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of such cessation of Board service. However, each option held by the Optionee under this Director Fee Option Grant Program at the time of his or her cessation of Board service shall immediately terminate and cease to remain outstanding with respect to any and all shares of Common Stock for which the option is not otherwise at that time exercisable.

E. **Death or Permanent Disability.** Should the Optionee's service as a Board member cease by reason of death or Permanent Disability, then each option held by such Optionee under this Director Fee Option Grant Program shall immediately become exercisable for all the shares of Common Stock at the time subject to that option, and the option may be exercised for any or all of those shares as fully-vested shares until the earlier of (i) the expiration of the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of such cessation of Board service.

Should the Optionee die after cessation of Board service but while holding one or more options under this Director Fee Option Grant Program, then each such option may be exercised, for any or all of the shares for which the option is exercisable at the time of the Optionee's cessation of Board service (less any shares subsequently purchased by Optionee prior to death), by the personal representative of the Optionee's estate or by the person or persons to whom the option is transferred pursuant to the Optionee's will or in accordance with the laws of descent and distribution. Such right of exercise shall lapse, and the option shall terminate, upon the earlier of (i) the expiration of the ten (10)-year option term or (ii) the three (3)-year period measured from the date of the Optionee's cessation of Board service.

III. CORPORATE TRANSACTION/CHANGE IN CONTROL/HOSTILE TAKE-OVER

A. In the event of any Corporate Transaction while the Optionee remains a Board member, each outstanding option held by such Optionee under this Director Fee Option Grant Program shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Corporate Transaction, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. Each such outstanding option shall be assumed by the successor corporation (or parent thereof) in the Corporate Transaction and shall remain exercisable for the fully-vested shares until the earlier of (i) the expiration of the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of the Optionee's cessation of Board service.

B. In the event of a Change in Control while the Optionee remains in Service, each outstanding option held by such Optionee under this Director Fee Option Grant Program shall automatically accelerate so that each such option shall immediately become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. The option shall remain so exercisable until the earlier or (i) the expiration of the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of the Optionee's cessation of Service.

C. Upon the occurrence of a Hostile Take-Over, the Optionee shall have a thirty (30)-day period in which to surrender to the Corporation each outstanding option granted him or her under the Director Fee Option Grant Program. The Optionee shall in return be entitled to a cash distribution from the Corporation in an amount equal to the excess of (i) the Take-Over Price of the shares of Common Stock at the time subject to each surrendered option (whether or not the Optionee is otherwise at the time vested in those shares) over (ii) the aggregate exercise price payable for such shares. Such cash distribution shall be paid within five (5) days following the surrender of the option to the Corporation. No approval or consent of the Board or any Plan Administrator shall be required in connection with such option surrender and cash distribution.

D. The grant of options under the Director Fee Option Grant Program shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

IV. REMAINING TERMS

The remaining terms of each option granted under this Director Fee Option Grant Program shall be the same as the terms in effect for option grants made under the Discretionary Option Grant Program.

ARTICLE SEVEN

MISCELLANEOUS

I. FINANCING

The Plan Administrator may permit any Optionee or Participant to pay the option exercise price under the Discretionary Option Grant Program or the purchase price of shares issued under the Stock Issuance Program by delivering a full-recourse, interest bearing promissory note payable in one or more installments. The terms of any such promissory note (including the interest rate and the terms of repayment) shall be established by the Plan Administrator in its sole discretion. In no event may the maximum credit available to the Optionee or Participant exceed the sum of (i) the aggregate option exercise price or purchase price payable for the purchased shares plus (ii) any Federal, state and local income and employment tax liability incurred by the Optionee or the Participant in connection with the option exercise or share purchase.

II. TAX WITHHOLDING

A. The Corporation’s obligation to deliver shares of Common Stock upon the exercise of options or the issuance or vesting of such shares under the Plan shall be subject to the satisfaction of all applicable Federal, state and local income and employment tax withholding requirements.

B. The Plan Administrator may, in its discretion, provide any or all holders of Non-Statutory Options or unvested shares of Common Stock under the Plan (other than the options granted or the shares issued under the Automatic Option Grant or Director Fee Option Grant Program) with the right to use shares of Common Stock in satisfaction of all or part of the Taxes incurred by such holders in connection with the exercise of their options or the vesting of their shares. Such right may be provided to any such holder in either or both of the following formats:

Stock Withholding: The election to have the Corporation withhold, from the shares of Common Stock otherwise issuable upon the exercise of such Non-Statutory Option or the vesting of such shares, a portion of those shares with an aggregate Fair Market Value equal to the percentage of the Taxes (not to exceed one hundred percent (100%)) designated by the holder.

Stock Delivery: The election to deliver to the Corporation, at the time the Non-Statutory Option is exercised or the shares vest, one or more shares of Common Stock previously acquired by such holder (other than in connection with the option exercise or share vesting triggering the Taxes) with an aggregate Fair Market Value equal to the percentage of the Taxes (not to exceed one hundred percent (100%)) designated by the holder.

III. EFFECTIVE DATE AND TERM OF THE PLAN

A. The Plan was initially adopted by the Board on May 31, 1996, and was subsequently approved by the stockholders. The Discretionary Option Grant and the Stock Issuance Programs became effective immediately upon the Plan Effective Date.

B. The Automatic Option Grant Program became effective on the Underwriting Date. The Plan was subsequently amended by the Board on December 22, 1997 to (i) increase the maximum number of shares of Common Stock authorized for issuance under the Plan by 7,600,000 shares, (ii) allow individuals who administer the Plan to be included in the group of non-associate Board members eligible to receive option grants and direct stock issuances under the Discretionary Option Grant and Stock Issuance Programs, (iii) remove certain restrictions on the eligibility of non-associate Board members to serve as Plan Administrator, and (iv) effect a series of technical changes to the provisions of the Plan (including stockholder approval requirements, certain holding period restrictions, and the frequency of which the Automatic Option Grant Program may be amended) in order to take advantage of the November 1996 amendments to Rule 16b-3 of the 1934 Act which exempts certain officer and director transactions under the Plan from the short-swing liability provisions of the federal securities laws ("December 1997 Amendment"). The December 1997 Amendment was approved by the stockholders at the 1998 Annual Meeting.

C. On October 21, 1998, the Board amended and restated the Plan to increase the maximum number of shares of Common Stock authorized for issuance under the Plan by 11,000,000 shares, to 58,576,480 shares of Common Stock. On December 24, 1998 the Board again amended and restated the Plan to incorporate the Salary Investment Option Grant and Director Fee Option Grant Programs. Both Amendments were approved by the stockholders at the 1999 Annual Meeting. The Salary Investment Option Grant Program and Director Fee Option Program shall not be implemented until such time as the Primary Committee may deem appropriate. The option grants made prior to the October 1998 Amendment shall remain outstanding in accordance with the terms and conditions of the respective instruments evidencing those options or issuances and nothing in the October 1998 Amendment shall be deemed to modify or in any away affect those outstanding options or issuances.

D. On December 21, 1999, the Board amended and restated the Plan to increase the maximum number of shares of Common Stock authorized for issuance under the Plan by 11,900,000 shares, to 70,476,480 shares of Common Stock. The Amendment was concurrently approved by the stockholders on December 21, 1999. The option grants made prior to the December 1999 Amendment shall remain outstanding in accordance with the terms and conditions of the respective instruments evidencing those options or issuances and nothing in the December 1999 Amendment shall be deemed to modify or in any away affect those outstanding options or issuances.

E. On April 19, 2000, the Board amended and restated the Plan to reduce the number of shares granted upon the initial grant to new non-associate Board members under Article Five of the Plan from 80,000 shares of Common Stock to 50,000 shares of Common Stock.

F. On October 25, 2000, the Board amended and restated the Plan to (i) increase the maximum number of shares of Common Stock authorized for issuance under the Plan by 14,923,512 shares, subject to stockholder approval at the 2000 Annual Meeting, (ii) to provide that the number of shares of Common Stock available for issuance under the Plan shall automatically increase, on the first trading day of January of each calendar year in the four (4) calendar-year period beginning with the 2002 calendar year and continuing through the share increase effected for calendar year 2005, by an amount equal to five percent (5%) of the total number of shares of Common Stock outstanding on the last trading day in December of the immediately preceding calendar year, subject to stockholder approval at the 2000 Annual Meeting, and (iii) to increase the maximum number of shares which any one person participating in the Plan may receive during any one calendar year in options, separately exercisable stock appreciation rights and direct stock issuances to 6,000,000 shares, subject to stockholder approval at the 2000 Annual Meeting. Each Amendment was approved by the shareholders at the 2000 Annual Meeting on December 21, 2000. The option grants made prior to the October 2000 Amendment shall remain outstanding in accordance with the terms and conditions of the respective instruments evidencing those options or issuances and nothing in the October 2000 Amendment shall be deemed to modify or in any away affect those outstanding options or issuances.

G. On April 4, 2002, the Board amended and restated the Plan to eliminate the authority of the Plan Administrator to cancel and regrant options under then Article Two, Section IV of the Plan. All cancelled and regranted options made prior to the April 2002 Amendment shall remain outstanding in accordance with the terms and conditions of the respective instruments evidencing those options or issuances and nothing in the April 2002 Amendment shall be deemed to modify or in any away affect those outstanding options or issuances. Subject to the foregoing limitations, the Plan Administrator may make option grants under the Plan at any time before the date fixed herein for the termination of the Plan.

H. The Plan shall serve as the successor to the Predecessor Plan, and no further option grants or direct stock issuances shall be made under the Predecessor Plan after the Section 12(g) Registration Date. All options outstanding under the Predecessor Plan on the Section 12(g) Registration Date shall be incorporated into the Plan at that time and shall be treated as outstanding options under the Plan. However, each outstanding option so incorporated shall continue to be governed solely by the terms of the documents evidencing such option, and no provision of the Plan shall be deemed to affect or otherwise modify the rights or obligations of the holders of such incorporated options with respect to their acquisition of shares of Common Stock.

I. One or more provisions of the Plan, including (without limitation) the option/vesting acceleration provisions of Article Two relating to Corporate Transactions and Changes in Control, may, in the Plan Administrator's discretion, be extended to one or more options incorporated from the Predecessor Plan which do not otherwise contain such provisions.

J. The Plan shall terminate upon the earliest of (i) May 30, 2006, (ii) the date on which all shares available for issuance under the Plan shall have been issued as fully-vested shares or (iii) the termination of all outstanding options in connection with a Corporate

Transaction. Upon such plan termination, all outstanding option grants and unvested stock issuances shall thereafter continue to have force and effect in accordance with the provisions of the documents evidencing such grants or issuances.

IV. AMENDMENT OF THE PLAN

A. The Board shall have complete and exclusive power and authority to amend or modify the Plan in any or all respects. However, no such amendment or modification shall adversely affect the rights and obligations with respect to stock options or unvested stock issuances at the time outstanding under the Plan unless the Optionee or the Participant consents to such amendment or modification. In addition, certain amendments may require stockholder approval pursuant to applicable laws or regulations.

B. Options to purchase shares of Common Stock may be granted under the Discretionary Option Grant and Salary Investment Option Grant Programs and shares of Common Stock may be issued under the Stock Issuance Program that are in each instance in excess of the number of shares then available for issuance under the Plan, provided any excess shares actually issued under those programs shall be held in escrow until there is obtained stockholder approval of an amendment sufficiently increasing the number of shares of Common Stock available for issuance under the Plan. If such stockholder approval is not obtained within twelve (12) months after the date the first such excess issuances are made, then (i) any unexercised options granted on the basis of such excess shares shall terminate and cease to be outstanding and (ii) the Corporation shall promptly refund to the Optionees and the Participants the exercise or purchase price paid for any excess shares issued under the Plan and held in escrow, together with interest (at the applicable Short Term Federal Rate) for the period the shares were held in escrow, and such shares shall thereupon be automatically cancelled and cease to be outstanding.

V. USE OF PROCEEDS

Any cash proceeds received by the Corporation from the sale of shares of Common Stock under the Plan shall be used for general corporate purposes.

VI. REGULATORY APPROVALS

A. The implementation of the Plan, the granting of any stock option under the Plan and the issuance of any shares of Common Stock (i) upon the exercise of any granted option or (ii) under the Stock Issuance Program shall be subject to the Corporation's procurement of all approvals and permits required by regulatory authorities having jurisdiction over the Plan, the stock options granted under it and the shares of Common Stock issued pursuant to it.

B. No shares of Common Stock or other assets shall be issued or delivered under the Plan unless and until there shall have been compliance with all applicable requirements of Federal and state securities laws, including the filing and effectiveness of the Form S-8 registration statement for the shares of Common Stock issuable under the Plan, and all applicable listing requirements of any stock exchange (or the Nasdaq National Market, if applicable) on which Common Stock is then listed for trading.

VII. NO EMPLOYMENT/SERVICE RIGHTS

Nothing in the Plan shall confer upon the Optionee or the Participant any right to continue in Service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining such person) or of the Optionee or the Participant, which rights are hereby expressly reserved by each, to terminate such person's Service at any time for any reason, with or without cause.

APPENDIX

The following definitions shall be in effect under the Plan:

A. **Associate** shall mean an individual who is in the employ of the Corporation (or any Parent or Subsidiary), subject to the control and direction of the employer entity as to both the work to be performed and the manner and method of performance.

B. **Automatic Option Grant Program** shall mean the automatic option grant program in effect under the Plan.

C. **Board** shall mean the Corporation's Board of Directors.

D. **Change in Control** shall mean a change in ownership or control of the Corporation effected through either of the following transactions:

(i) the acquisition, directly or indirectly by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation), of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) of securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders which the Board does not recommend such stockholders to accept, or

(ii) a change in the composition of the Board over a period of thirty-six (36) consecutive months or less such that a majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (A) have been Board members continuously since the beginning of such period or (B) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (A) who were still in office at the time the Board approved such election or nomination.

E. **Code** shall mean the Internal Revenue Code of 1986, as amended.

F. **Common Stock** shall mean the Corporation's common stock.

G. **Corporate Transaction** shall mean either of the following stockholder-approved transactions to which the Corporation is a party:

(i) a merger or consolidation in which securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such transaction, or

(ii) the sale, transfer or other disposition of all or substantially all of the Corporation's assets in complete liquidation or dissolution of the Corporation.

H. **Corporation** shall mean E*TRADE Group, Inc. and any corporate successor to all or substantially all of the assets or voting stock of E*TRADE Group, Inc. which shall by appropriate action adopt the Plan.

I. **Discretionary Option Grant Program** shall mean the discretionary option grant program in effect under the Plan.

J. **Director Fee Option Grant Program** shall mean the special stock option grant in effect for non-associate Board members under Article Six of the Plan.

K. **Eligible Director** shall mean a non-associate Board member eligible to participate in the Automatic Option Grant Program in accordance with the eligibility provisions of Article One.

L. **Exercise Date** shall mean the date on which the Corporation shall have received written notice of the option exercise.

M. **Fair Market Value** per share of Common Stock on any relevant date shall be determined in accordance with the following provisions:

(i) If the Common Stock is at the time traded on the Nasdaq National Market, 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, as the price is reported by the National Association of Securities Dealers on the Nasdaq National Market or any successor system. If there is no average of the high and low selling prices per share for the Common Stock on the date in question, then the Fair Market Value shall be the average of the high and low selling prices per share on the last preceding date for which such quotation exists.

(ii) If the Common Stock is at the time listed on any Stock Exchange, then the Fair Market Value shall be the average of the high and low selling prices per of Common Stock on the date in question on the Stock Exchange determined by the Plan Administrator to be the primary market for the Common Stock, as such price is officially quoted in the composite tape of transactions on such exchange. If there is no average of the high and low selling prices per share for the Common Stock on the date in question, then the Fair Market Value shall be the average of the high and low selling prices per share on the last preceding date for which such quotation exists.

(iii) For purposes of any option grants made on the Underwriting Date, the Fair Market Value shall be deemed to be equal to the price per share at which the Common Stock is to be sold in the initial public offering pursuant to the Underwriting Agreement.

(iv) For purposes of any option grants made prior to the Underwriting Date, the Fair Market Value shall be determined by the Plan Administrator, after taking into account such factors as it deems appropriate.

N. **Hostile Take-Over** shall mean a change in ownership of the Corporation effected through the acquisition, directly or indirectly, by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation) of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) of securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders which the Board does not recommend such stockholders to accept.

O. **Incentive Option** shall mean an option which satisfies the requirements of Code Section 422.

P. **Involuntary Termination** shall mean the termination of the Service of any individual which occurs by reason of:

(i) such individual's involuntary dismissal or discharge by the Corporation for reasons other than Misconduct, or

(ii) such individual's voluntary resignation following (A) a change in his or her position with the Corporation which materially reduces his or her level of responsibility, (B) a reduction in his or her level of compensation (including base salary, fringe benefits and participation in any corporate-performance based bonus or incentive programs) by more than fifteen percent (15%) or (C) a relocation of such individual's place of employment by more than fifty (50) miles, provided and only if such change, reduction or relocation is effected by the Corporation without the individual's consent.

Q. **Misconduct** shall mean the commission of any act of fraud, embezzlement or dishonesty by the Optionee or Participant, any unauthorized use or disclosure by such person of confidential information or trade secrets of the Corporation (or any Parent or Subsidiary), or any other intentional misconduct by such person adversely affecting the business or affairs of the Corporation (or any Parent or Subsidiary) in a material manner. The foregoing definition shall not be deemed to be inclusive of all the acts or omissions which the Corporation (or any Parent or Subsidiary) may consider as grounds for the dismissal or discharge of any

Optionee, Participant or other person in the Service of the Corporation (or any Parent or Subsidiary).

R. **1934 Act** shall mean the Securities Exchange Act of 1934, as amended.

S. **Non-Statutory Option** shall mean an option not intended to satisfy the requirements of Code Section 422.

T. **Optionee** shall mean any person to whom an option is granted under the Discretionary Option Grant, Salary Investment Option Grant, Automatic Option Grant or Director Fee Program.

U. **Parent** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations ending with the Corporation, provided each corporation in the unbroken chain (other than the Corporation) owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

V. **Participant** shall mean any person who is issued shares of Common Stock under the Stock Issuance Program.

W. **Permanent Disability or Permanently Disabled** shall mean the inability of the Optionee or the Participant to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more. However, solely for purposes of the Automatic Option Grant and Director Fee Option Grant Programs, Permanent Disability or Permanently Disabled shall mean the inability of the non-associate Board member to perform his or her usual duties as a Board member by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more.

X. **Plan** shall mean the Corporation's 1996 Stock Incentive Plan, as set forth in this document.

Y. **Plan Administrator** shall mean the particular entity, whether the Primary Committee, the Board or the Secondary Committee, which is authorized to administer the Discretionary Option Grant and Stock Issuance Programs with respect to one or more classes of eligible persons, to the extent such entity is carrying out its administrative functions under those programs with respect to the persons under its jurisdiction.

Z. **Plan Effective Date** shall mean May 31, 1996, the date on which the Plan was adopted by the Board.

AA. **Predecessor Plan** shall mean the Corporation's pre-existing 1993 Stock Option Plan (which is the successor to the 1983 Employee Incentive Stock Option Plan) in effect immediately prior to the Plan Effective Date hereunder.

BB. **Primary Committee** shall mean the committee of two (2) or more non-associate Board members appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to Section 16 Insiders and to administer the Salary Investment Option Grant Program solely with respect to the selection of the eligible individuals who may participate in such program.

CC. **Salary Investment Option Grant Program** shall mean the salary investment option grant program in effect under the Plan.

DD. **Secondary Committee** shall mean a committee of one (1) or more Board members appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to eligible persons other than Section 16 Insiders.

EE. **Section 12 Registration Date** shall mean the date on which the Common Stock was first registered under Section 12(g) of the 1934 Act.

FF. **Section 16 Insider** shall mean an officer or director of the Corporation subject to the short-swing profit liabilities of Section 16 of the 1934 Act.

GG. **Service** shall mean the performance of services for the Corporation (or any Parent or Subsidiary) by a person in the capacity of an Associate, a non-associate member of the board of directors or a consultant or independent advisor, except to the extent otherwise specifically provided in the documents evidencing the option grant or stock issuance.

HH. **Stock Exchange** shall mean either the American Stock Exchange or the New York Stock Exchange.

II. **Stock Issuance Agreement** shall mean the agreement entered into by the Corporation and the Participant at the time of issuance of shares of Common Stock under the Stock Issuance Program.

JJ. **Stock Issuance Program** shall mean the stock issuance program in effect under the Plan.

KK. **Subsidiary** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations beginning with the Corporation, provided each corporation (other than the last corporation) in the unbroken chain owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

LL. **Take-Over Price** shall mean the greater of (i) the Fair Market Value per share of Common Stock on the date the option is surrendered to the Corporation in connection with a Hostile Take-Over or (ii) the highest reported price per share of Common Stock paid by the tender offeror in effecting such Hostile Take-Over. However, if the surrendered option is an Incentive Option, the Take-Over Price shall not exceed the clause (i) price per share.

MM. **Taxes** shall mean the Federal, state and local income and employment tax liabilities incurred by the holder of Non-Statutory Options or unvested shares of Common Stock in connection with the exercise of those options or the vesting of those shares.

NN. **10% Stockholder** shall mean the owner of stock (as determined under Code Section 424(d)) possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Corporation (or any Parent or Subsidiary).

OO. **Underwriting Agreement** shall mean the agreement between the Corporation and the underwriter or underwriters who managed the initial public offering of the Common Stock.

PP. **Underwriting Date** shall mean August 15, 1996, which is the date on which the Underwriting Agreement was executed and priced in connection with an initial public offering of the Common Stock.