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

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

Amendment No. 1

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

For the quarterly period ended February 28, 2007

or

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

For the transition period from _____ to _____

Commission file number 1-8989

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

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

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

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

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

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

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

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

EXPLANATORY NOTE

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

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AVAILABLE INFORMATION

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

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

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

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

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THE BEAR STEARNS COMPANIES INC. Condensed Consolidated Statements of Income

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

See Notes to Condensed Consolidated Financial Statements.

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

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

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

See Notes to Condensed Consolidated Financial Statements.

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

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

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

Supplemental Disclosure of Cash Flow Information:

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

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

Note: Certain prior period amounts have been reclassified to conform to the

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current period's presentation.

See Notes to Condensed Consolidated Financial Statements.

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

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

Basis of Presentation

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

As of December 1, 2006, the Company has fully adopted Emerging Issues Task Force ("EITF") Issue No. 04-5 "Determining Whether a General Partner, or

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the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." The EITF consensus requires a general partner in a limited partnership to consolidate the limited partnership unless the presumption of control is overcome. The general partner may overcome this presumption of control and not consolidate the entity if the limited partners have: (a) the substantive ability to dissolve or liquidate the limited partnership or otherwise remove the general partner without having to show cause; or (b) substantive participating rights in managing the partnership.

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

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

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

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

Financial Instruments

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

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Transactions" revenues in the Condensed Consolidated Statements of Income.

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

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

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

Derivative Instruments and Hedging Activities

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

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

On December 1, 2006, the Company adopted SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments--an amendment of FASB Statements No. 133 and 140." SFAS No. 155 permits companies to elect on an instrument-by-instrument basis, to apply a fair value measurement to hybrid financial instruments that contain an embedded derivative that

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

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

Customer Transactions

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

Mortgage Servicing Assets, Fees and Advances

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

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

underlying properties. A charge to earnings is recognized to the extent

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that servicing advances are estimated to be uncollectible under the provisions of the servicing contracts.

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

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

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

Collateralized Securities Transactions

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

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

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Investment Banking and Advisory Services

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

Commissions

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

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

Asset Management and Other Income

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

Fixed Assets

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

Goodwill and Identifiable Intangible Assets

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

Earnings Per Share

Earnings per share ("EPS") is computed in accordance with SFAS No. 128, "Earnings Per Share." Basic EPS is computed by dividing net income applicable to common shares, adjusted for costs related to vested shares under the Capital Accumulation Plan for Senior Managing Directors, as amended ("CAP Plan"), as well as the effect of the redemption of preferred stock, by the weighted average number of common shares outstanding. Common

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

Stock-Based Compensation

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

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Cash Equivalents

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

Income Taxes

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

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

Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at period end rates of exchange, while income statement items are translated at daily average rates of exchange during the fiscal period. Comprehensive

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income was materially the same as net income for the Company for the three months ended February 28, 2007 and 2006. Gains or losses resulting from foreign currency transactions are included in net income.

Accounting and Reporting Developments

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

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

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

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on the Condensed Consolidated Financial Statements of the Company.

2. FINANCIAL INSTRUMENTS

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

| (in thousands) | February 28, 2007 | November 30, 2006 |
|----------------|----------------------|----------------------|
|----------------|----------------------|----------------------|

FINANCIAL INSTRUMENTS OWNED:

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| | | |
|---------------------------------------|----------------|----------------|
| U.S. government and agency | \$ 5,246,453 | \$ 6,136,191 |
| Other sovereign governments | 2,456,191 | 1,371,713 |
| Corporate equity and convertible debt | 36,423,135 | 28,892,588 |
| Corporate debt and other | 35,208,016 | 33,924,116 |
| Mortgages, mortgage- and asset-backed | 57,549,272 | 43,226,699 |
| Derivative financial instruments | 10,281,472 | 11,617,144 |
| | | |
| | \$ 147,164,539 | \$ 125,168,451 |
| | | |

FINANCIAL INSTRUMENTS SOLD,
BUT NOT YET PURCHASED:

| | | |
|---------------------------------------|---------------|---------------|
| U.S. government and agency | \$ 10,736,633 | \$ 11,724,095 |
| Other sovereign governments | 3,900,955 | 1,275,145 |
| Corporate equity and convertible debt | 12,408,671 | 12,623,291 |
| Corporate debt and other | 5,062,733 | 4,714,019 |
| Mortgages, mortgage- and asset-backed | 35,320 | 54,802 |
| Derivative financial instruments | 10,134,938 | 11,865,192 |
| | | |
| | \$ 42,279,250 | \$ 42,256,544 |
| | | |

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

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

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

Concentration Risk

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

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

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

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

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

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

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

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

Assets at Fair Value as of February 28, 2007

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

Liabilities at Fair Value as of February 28, 2007

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

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

As stated above SFAS No. 157 applies to all financial assets and liabilities that are reported on a fair value basis. These valuations are adjusted for various factors including credit risk. For applicable

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financial assets carried at fair value, the credit standing of the counterparties is analyzed and factored into the fair value measurement of those assets. SFAS No. 157 states that the fair value measurement of a liability must reflect the nonperformance risk of the entity. Therefore, the impact of credit standing as well as any potential credit enhancements (e.g. collateral) has been factored into the fair value measurement of both financial assets and liabilities.

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

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

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

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

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

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

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

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

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

3. DERIVATIVES AND HEDGING ACTIVITIES

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

obligation, to

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

Market Risk

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

Derivatives Credit Risk

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

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

Non-Trading Derivatives Activity

To modify the interest rate characteristics of its long- and short-term debt, the Company also engages in non-trading derivatives activities. The Company has issued US dollar- and foreign currency-denominated debt with both variable- and fixed-rate interest payment obligations. The Company has entered into interest rate swaps, primarily based on LIBOR, to convert fixed-rate interest payments on its debt obligations into variable-rate

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payments. In addition, for foreign currency debt obligations that are not used to fund assets in the same currency, the Company has entered into currency swap agreements that effectively convert the debt into US dollar obligations. Such transactions are accounted for as fair value hedges.

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

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

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

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

4. TRANSFERS OF FINANCIAL ASSETS AND LIABILITIES

Securitizations

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

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

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

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The Company's securitization activities are detailed below:

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

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

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

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

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

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

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

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

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

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

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

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

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

Mortgage Servicing Rights

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

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

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

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

| | | |
|---------------------|--------------|-------|
| | February 28, | |
| (in millions) | 2007 | |
| ----- | ----- | ----- |
| Fair Value of MSR's | \$ | 580.0 |

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

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

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

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

5. VARIABLE INTEREST ENTITIES AND MORTGAGE LOAN SPECIAL PURPOSE ENTITIES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6. COLLATERALIZED FINANCING ARRANGEMENTS

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

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

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

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

7. LONG-TERM BORROWINGS

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

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

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

8. EARNINGS PER SHARE

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

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

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

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

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

9. REGULATORY REQUIREMENTS

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

Bear Stearns and BSSC are registered broker-dealers and futures commission merchants and, accordingly, are subject to Rule 15c3-1 under the Securities Exchange Act of 1934 ("Net Capital Rule") and Rule 1.17 under the Commodity Futures Trading Commission. Bear Stearns uses Appendix E of the Net Capital Rule which establishes alternative net capital requirements for broker-dealers that are part of consolidated supervised

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entities. Appendix E allows Bear Stearns to calculate net capital charges for market risk and derivatives-related credit risk based on mathematical models provided that Bear Stearns holds tentative net capital in excess of \$1 billion and net capital in excess of \$500 million. At February 28, 2007, Bear Stearns' net capital of \$3.65 billion exceeded the minimum requirement by \$3.10 billion. Bear Stearns' net capital computation, as defined, includes \$561.7 million, which is net capital of BSSC in excess of 5.5% of aggregate debit items arising from customer transactions.

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

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

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

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

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

10. COMMITMENTS AND CONTINGENCIES

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

Leases

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

(in thousands)

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

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Total \$1,098,876

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Lending - Related Commitments

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

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

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

Private Equity-Related Investments and Partnerships

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

Underwriting

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

Commercial and Residential Loans

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

Letters of Credit

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

Other

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

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

Litigation

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

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

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

Because litigation is inherently unpredictable, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief might be. Consequently, the Company cannot estimate losses or ranges of losses for matters where there is only a reasonable possibility that a loss may have

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been incurred. Although the ultimate outcome of these matters cannot be ascertained at this time, it is the opinion of management, after consultation with counsel, that the resolution of the foregoing matters will not have a material adverse effect on the financial condition of the Company, taken as a whole; such resolution may, however, have a material effect on the operating results in any future period, depending on the level of income for such period.

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

Tax

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

11. GUARANTEES

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

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

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

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

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

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

Derivative Contracts

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

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

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

Municipal Securities

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

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Residual Value Guarantee

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

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

Indemnifications

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

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

Other Guarantees

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

12. SEGMENT DATA

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

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

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

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

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

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

The three business segments comprise many business areas, with interactions among each. Revenues and expenses include those that are directly related to each segment. Revenues from intersegment transactions are based upon specific criteria or agreed upon rates with such amounts eliminated in consolidation. Individual segments also include revenues and expenses relating to various items, including corporate overhead and interest, which are internally allocated by the Company primarily based on balance sheet usage or expense levels. The Company generally evaluates performance of the segments based on net revenues and profit or loss before provision for income taxes.

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| (in thousands) | Three Months Ended | |
|-----------------------------|----------------------|----------------------|
| | February 28, 2007 | February 28, 2006 |
| NET REVENUES | | |
| Capital Markets | | |
| Institutional Equities | \$ 512,653 | \$ 499,893 |
| Fixed Income | 1,149,352 | 907,138 |
| Investment Banking | 303,109 | 295,550 |
| Total Capital Markets | 1,965,114 | 1,702,581 |
| Global Clearing Services | 275,558 | 263,425 |
| Wealth Management | | |
| Private Client Services (1) | 136,153 | 129,611 |
| Asset Management | 119,159 | 95,076 |
| Total Wealth Management | 255,312 | 224,687 |
| Other (2) | (14,212) | (5,490) |
| Total net revenues | \$ 2,481,772 | \$ 2,185,203 |
| PRE-TAX INCOME | | |
| Capital Markets | \$ 736,311 | \$ 652,327 |
| Global Clearing Services | 112,800 | 124,859 |
| Wealth Management | 43,753 | 31,786 |
| Other (3) | (57,658) | (56,619) |
| Total pre-tax income | \$ 835,206 | \$ 752,353 |

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(1) Private Client Services

| (in thousands) | Three Months Ended | |
|--|----------------------|----------------------|
| | February 28, 2007 | February 28, 2006 |
| Gross revenues, before transfer to Capital Markets segment | | |
| Capital Markets segment | \$ 165,589 | \$ 153,895 |
| Revenue transferred to Capital Markets segment | (29,436) | (24,284) |
| Private Client Services net revenues | \$ 136,153 | \$ 129,611 |

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- (2) Includes consolidation and elimination entries.
- (3) Includes certain legal costs and costs related to the CAP Plan.

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

| | As of | |
|--------------------------|----------------------|----------------------|
| (in thousands) | February 28, 2007 | February 28, 2006 |
| SEGMENT ASSETS | | |
| Capital Markets | \$ 278,015,971 | \$ 240,448,857 |
| Global Clearing Services | 101,082,764 | 98,532,526 |
| Wealth Management | 3,981,070 | 3,138,239 |
| Other | 11,432,120 | 8,312,973 |
| Total segment assets | | |
| | \$ 394,511,925 | \$ 350,432,595 |

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

The Bear Stearns Companies Inc.

We have reviewed the accompanying condensed consolidated statement of financial condition of The Bear Stearns Companies Inc. and subsidiaries as of February 28, 2007, and the related condensed consolidated statements of income and cash flows for the three-month periods ended February 28, 2007 and 2006. These interim financial statements are the responsibility of The Bear Stearns Companies Inc.'s management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of The Bear Stearns Companies Inc. and subsidiaries as of November 30, 2006, and the related consolidated statements of income, cash flows and changes in stockholders' equity for the fiscal year then ended (not presented herein); and in our report dated February 12, 2007, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement

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of financial condition as of November 30, 2006 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

/s/ Deloitte & Touche LLP
New York, New York
April 6, 2007

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

INTRODUCTION

The Bear Stearns Companies Inc. (the "Company") is a holding company that through its broker-dealer and international bank subsidiaries, principally Bear, Stearns & Co. Inc. ("Bear Stearns"), Bear, Stearns Securities Corp. ("BSSC"), Bear, Stearns International Limited ("BSIL") and Bear Stearns Bank plc ("BSB"), is a leading investment banking, securities and derivatives trading, clearance and brokerage firm serving corporations, governments, institutional and individual investors worldwide. BSSC, a subsidiary of Bear Stearns, provides professional and correspondent clearing services in addition to clearing and settling customer transactions and certain proprietary transactions of the Company. The Company also conducts significant activities through other wholly owned subsidiaries, including: Bear Stearns Global Lending Limited; Custodial Trust Company; Bear Stearns Financial Products Inc.; Bear Stearns Capital Markets Inc.; Bear Stearns Credit Products Inc.; Bear Stearns Forex Inc.; EMC Mortgage Corporation; Bear Stearns Commercial Mortgage, Inc.; and through its majority owned subsidiary Bear Hunter Holdings LLC. The Company is primarily engaged in business as a securities broker-dealer operating in three principal segments: Capital Markets, Global Clearing Services and Wealth Management. As used in this report, the "Company" refers (unless the context requires otherwise) to The Bear Stearns Companies Inc. and its subsidiaries. Unless specifically noted otherwise, all references to the three months of 2007 and 2006 refer to the three months ended February 28, 2007 and 2006, respectively, and all references to quarters are to the Company's fiscal quarters.

For a description of the Company's business, including its trading in cash instruments and derivative products, its underwriting and trading policies, and their respective risks, and the Company's risk management policies and procedures, see the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2006, as filed by the Company under the Securities Exchange Act of 1934, as amended ("Exchange Act").

The Management's Discussion and Analysis of Financial Condition and Results of Operations should be read together with the Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements in the Company's Annual Report on Form 10-K.

CERTAIN FACTORS AFFECTING RESULTS OF OPERATIONS

The Company's principal business activities--investment banking, securities and derivatives sales and trading, clearance, brokerage and asset management--are, by their nature, highly competitive and subject to various risks, including volatile trading markets and fluctuations in the volume of market activity. Consequently, the Company's net income and revenues have been, and are likely to continue to be, subject to wide fluctuations, reflecting the effect of many factors, including general economic conditions, securities market conditions,

the level and volatility of interest rates and equity prices, competitive conditions, liquidity of global markets, international and regional political conditions, regulatory and legislative developments, monetary and fiscal policy, investor sentiment, availability and cost of capital, technological changes and events, outcome of legal proceedings, changes in currency values, inflation, credit ratings and the size, volume and timing of transactions.

These and other factors can affect the Company's volume of new securities issuances, mergers and acquisitions and business restructurings; the stability and liquidity of securities and futures markets; and ability of issuers, other securities firms and counterparties to perform on their obligations. A decrease in the volume of new securities issuances, mergers and acquisitions or restructurings generally results in lower revenues from investment banking and, to a lesser extent, reduced principal transactions. A reduced volume of securities and futures transactions and reduced market liquidity generally results in lower revenues from principal transactions and commissions. Lower price levels for securities may result in a reduced volume of transactions, and may also result in losses from declines in the market value of securities held in proprietary trading and underwriting accounts. In periods of reduced sales and trading or investment banking activity, profitability may be adversely affected because certain expenses remain relatively fixed. The Company's securities trading, derivatives, arbitrage, market-making, specialist, leveraged lending, leveraged buyout and underwriting activities are conducted by it on a principal basis and expose the Company to significant risk of loss. Such risks include market, counterparty credit and liquidity risks. For a discussion of how the Company seeks to manage risks, see the "Risk Management" and "Liquidity and Capital Resources" sections of the Company's Annual Report on Form 10-K.

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MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Company tests goodwill for impairment at least annually in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." In addition, as required, the Company amortizes identifiable intangible assets over their useful lives and tests for impairment whenever events or changes in circumstances suggest the carrying value of an asset or asset group may not be fully recoverable. The majority of the Company's goodwill and identifiable intangible assets relate to the acquisition of NYSE specialist rights. The Company's most recent annual goodwill impairment test did not result in an identified impairment. However, a prolonged period of weakness in the equity markets and/or certain events that could adversely affect the Company's specialist business could indicate a potential impairment in the value of goodwill and/or identifiable intangible assets.

Substantial legal liability or a significant regulatory action against the Company could have a material adverse effect or cause significant reputational harm to the Company, which in turn could seriously harm the Company's business prospects. Firms in the financial services industry have been operating in a stringent regulatory environment. The Company faces significant legal risks in its businesses, and the volume of claims and amount of damages and penalties claimed in litigation and regulatory proceedings against financial institutions have been increasing.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this discussion are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements concerning management's expectations, strategic

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objectives, business prospects, anticipated economic performance and financial condition and other similar matters are subject to risks and uncertainties, including those described in the prior paragraphs, which could cause actual results to differ materially from those discussed in the forward-looking statements. Forward-looking statements speak only as of the date of the document in which they are made. We disclaim any obligation or undertaking to provide any updates or revisions to any forward-looking statement to reflect any change in our expectations or any change in events, conditions or circumstances on which the forward-looking statement is based.

EXECUTIVE OVERVIEW

Summary of Results

Revenues, net of interest expense ("net revenues") for the three months ended February 28, 2007 increased 13.6% to \$2.48 billion from \$2.19 billion for the three months ended February 28, 2006, while pre-tax earnings increased 11.0% during the same period. Pre-tax profit margins for the 2007 quarter decreased to 33.7% when compared with 34.4% in the 2006 quarter. Annualized return on average common equity was 18.3% for the quarter ended February 28, 2007 compared with 20.1% in the 2006 quarter.

The increases in net revenues and pre-tax earnings in the first quarter of 2007 reflect increased net revenues in all three segments and all geographic regions. Capital Markets net revenues increased substantially from the 2006 quarter driven by strong performances from the institutional equities, structured equity products, international equity sales and trading and risk arbitrage businesses, reflecting favorable market conditions. Partially offsetting these results were reduced net revenues from our New York Stock Exchange ("NYSE") specialist activities and energy related activities. The prior year quarter included a significant gain from the monetization of certain energy properties. Fixed income net revenues increased substantially from the prior year quarter on record levels from the credit businesses, particularly credit trading and distressed trading, on tighter spreads and increased activity. In addition, interest rate derivatives had a strong quarter reflecting higher volatility and customer volumes. Partially offsetting these increases were decreased mortgage related net revenues during the quarter. Although volumes were strong during most of the quarter, mortgage markets became more challenging later in the quarter as investor concern over the rising delinquency levels in the subprime mortgage market escalated. Investment banking net revenues increased reflecting a favorable mergers and acquisitions ("M&A") environment and an active calendar for equity and high yield underwritings. The investment banking increases were partially offset by reduced merchant banking revenues.

Global Clearing Services net revenues increased in the 2007 quarter. Net interest revenues continued to increase but were partially offset by reduced commission and other revenues. Prime broker margin debt and short balances reached record levels during the 2007 quarter.

Wealth Management net revenues increased during the 2007 quarter driven by increases in both Private Client Services ("PCS") and Asset Management net revenues. PCS revenues increased on improved retail activity, particularly higher fee-based income on advisory products. Asset Management net revenues increased on higher performance fees and management fees on both traditional and alternative assets under management.

From a geographical perspective, net revenues from our international activities increased by 59.2% to \$455 million.

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Business Environment

Fiscal 2007 Quarter

The business environment during the Company's first quarter ended February 28, 2007 was generally favorable due to a combination of factors including low unemployment, low corporate interest rates, and strong consumer confidence. The unemployment rate dropped to 4.5% at the end of February 2007, reflecting a strong labor market. Additionally, the price of oil decreased from approximately \$63 a barrel at the beginning of the quarter and closed the quarter at approximately \$62 on February 28, 2007. The Federal Reserve Board (the "Fed") met twice during the 2007 quarter, leaving the federal funds rate unchanged at 5.25%, citing cooling of the housing market and moderate economic expansion.

Each of the major US equity indices increased during the 2007 quarter. The Standard & Poor's 500 Index ("S&P 500"), the Dow Jones Industrial Average ("DJIA"), and the Nasdaq Composite Index ("NASDAQ") increased 9.9%, 11.6% and 5.9%, respectively, during the 2007 quarter. Average daily trading volume on the NYSE decreased 7.7% while average daily trading volume on the Nasdaq increased 13.6% in the 2007 quarter, compared to the 2006 quarter. Industry-wide US-announced M&A volumes increased 196.2% while industry-wide US-completed M&A volumes increased 22.4% compared to the first quarter of 2006. Total equity issuance volumes increased 9.2% while initial public offering ("IPO") volumes increased 27.1% compared to the 2006 quarter.

Fixed income activity remained strong during the 2007 quarter as corporate credit spreads tightened and trading volumes increased. Long-term interest rates, as measured by the 10-year Treasury bond, remained relatively stable during the 2007 quarter. The 10-year Treasury bond yield was 4.57% at the end of the 2007 quarter, up from 4.46% at the beginning of the quarter. Overall US mortgage-backed securities new issue volume decreased 11.9% during the 2007 quarter compared with the strong results achieved in the 2006 quarter. Agency CMO volumes decreased approximately 35.1% industry-wide during the 2007 quarter from the levels reached in the 2006 quarter, while non-agency mortgage-backed originations volumes decreased approximately 8.5% industry-wide compared to the 2006 quarter. During February 2007, the ABX subprime mortgage credit indices widened dramatically, reflecting investor concern due to increased delinquencies in subprime mortgages. Through quarter end, problems in the subprime market had not spread to the broader mortgage market.

Fiscal 2006 Quarter

The business environment during the Company's first quarter ended February 28, 2006 was favorable due to a combination of factors including an expanding US economy, improved corporate profitability and low unemployment. The unemployment rate dropped to 4.7% in January 2006, its lowest level in 4 1/2 years. Despite these favorable factors, energy prices continued to be a concern during the 2006 quarter as the price of oil increased from approximately \$57 a barrel at the beginning of the quarter to approximately \$68 in January 2006 and closed the quarter at \$61 on February 28, 2006. The Fed met twice during the quarter, raising the federal funds rate, in 25 basis point increments, from 4.00% to 4.50%.

Each of the major US equity indices increased during the 2006 quarter. The S&P 500, the DJIA, and NASDAQ increased 2.5%, 1.7% and 2.2%, respectively, during the 2006 quarter. Average daily trading volume on the NYSE increased 9.2% while average daily trading volume on the Nasdaq decreased 4.9% in the 2006 quarter, compared to the 2005 quarter. Industry-wide US-announced M&A volumes decreased 15% while industry-wide US-completed M&A volumes increased 89% compared to the first quarter of 2005. Total equity issuance volumes increased 35% while IPOs volumes decreased 32% compared to the 2005 quarter.

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Fixed income activity was robust during the 2006 quarter despite the increase in short term interest rates and a flattening yield curve. While the Fed continued to raise the federal funds rate during the 2006 quarter, long-term interest rates, as measured by the 10-year Treasury bond, remained relatively stable during the 2006 quarter. The 10-year Treasury bond yield was 4.56% at the end of the 2006 quarter, up slightly from 4.50% at the beginning of the quarter. The housing market experienced declines in refinancing and purchasing levels as rates for 30-year fixed rate mortgages increased modestly during the 2006 quarter. The Mortgage Bankers Association Purchase Index and Mortgage Bankers Association Refinance Index decreased approximately 2% and 25%, respectively, compared to the 2005 quarter. However, overall US mortgage-backed

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securities new issue volume increased 25% during the 2006 quarter compared with the strong results achieved in the 2005 quarter. Agency CMO volumes increased approximately 5% industry-wide during the 2006 quarter from the levels reached in the 2005 quarter while non-agency mortgage-backed originations volumes increased approximately 33% industry-wide compared to the 2005 quarter.

RESULTS OF OPERATIONS

Firmwide Results

The following table sets forth an overview of the Company's financial results:

| (in thousands, except per share amounts, pre-tax profit margin and return on average common equity) | Three Months Ended | | |
|---|----------------------|----------------------|---------------|
| | February 28, 2007 | February 28, 2006 | % Increase |
| Revenues, net of interest expense | \$ 2,481,772 | \$ 2,185,203 | 13.6% |
| Income before provision for income taxes | \$ 835,206 | \$ 752,353 | 11.0% |
| Net Income | \$ 553,741 | \$ 514,156 | 7.7% |
| Diluted earnings per share | \$ 3.82 | \$ 3.54 | 7.9% |
| Pre-tax profit margin | 33.7% | 34.4% | |
| Return on average common equity (annualized) | 18.3% | 20.1% | |

The Company reported net income of \$553.7 million, or \$3.82 per share (diluted), for the quarter ended 2007, which represented an increase of 7.7% from \$514.2 million, and 7.9% from \$3.54 per share (diluted), for the quarter ended 2006. Net revenues increased 13.6% to \$2.48 billion for the quarter ended 2007 from \$2.19 billion for the quarter ended 2006, due to increases in principal transactions revenues, net interest revenues, asset management and other revenues and investment banking revenues, partially offset by a decrease in commission revenues.

The Company's commission revenues by reporting category were as follows:

| (in thousands) | Three Months Ended | | |
|----------------|----------------------|----------------------|--------------------------|
| | February 28, 2007 | February 28, 2006 | % Increase (Decrease) |
| Institutional | \$ 192,714 | \$ 188,440 | 2.3% |
| Clearance | 53,516 | 59,196 | (9.6%) |

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| | | | | |
|-------------------|----|---------|------------|---------|
| Retail | | 34,415 | 38,435 | (10.5%) |
| ----- | | | | |
| Total commissions | \$ | 280,645 | \$ 286,071 | (1.9%) |
| ----- | | | | |

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

Commission revenues for the 2007 quarter decreased 1.9% to \$280.6 million from \$286.1 million for the comparable prior year quarter. Institutional commissions remained stable, increasing 2.3% to \$192.7 million for the 2007 quarter from \$188.4 million for the comparable prior year quarter. Clearance commissions decreased 9.6% to \$53.5 million for the 2007 quarter from \$59.2 million for the comparable prior year quarter, reflecting lower trading volumes from fully-disclosed clients and lower average rates from prime broker clients. Retail commissions decreased 10.5% to \$34.4 million in the 2007 quarter from \$38.4 million in the comparable prior year quarter primarily due to the transfer of certain accounts from a commission-based to a fee-based platform.

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The Company's principal transactions revenues by reporting category were as follows:

| (in thousands) | Three Months Ended | | | % Increase |
|------------------------------|--------------------|-------------------|--|------------|
| | February 28, 2007 | February 28, 2006 | | |
| Fixed income | \$ 969,974 | \$ 802,917 | | 20.8% |
| Equities | 372,403 | 347,515 | | 7.2% |
| Total principal transactions | \$ 1,342,377 | \$ 1,150,432 | | 16.7% |

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

Revenues from principal transactions for the 2007 quarter increased 16.7% to \$1.34 billion from \$1.15 billion for the 2006 quarter due to increases in both fixed income and equities revenues. Fixed income revenues increased 20.8% to \$970 million for the 2007 quarter from \$802.9 million for the prior year quarter. Revenues from credit derivatives and distressed trading increased significantly as corporate credit spreads tightened and customer activity increased. Interest rate derivatives also increased in the 2007 quarter compared with the 2006 quarter, primarily attributable to higher interest rate volatility and increased customer volumes. Despite strong trading volumes during the 2007 quarter, the challenging market conditions in the subprime mortgage sector resulted in a decrease in mortgage-back securities revenues when compared to the 2006 quarter. Revenues derived from equities activities increased 7.2% to \$372.4 million during the 2007 quarter from \$347.5 million in the 2006 quarter. Structured equity products net revenues increased significantly on strong customer activities and favorable market conditions. In addition, revenues from international equity sales and trading increased, reflecting continued strength in both European and Asian equities. Risk arbitrage revenues also rose on higher levels of global announced M&A volumes. Partially offsetting these increases was a decrease in revenues from specialist activities and revenues from the Company's energy and commodity activities.

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The Company's investment banking revenues by reporting category were as follows:

| (in thousands) | Three Months Ended | | |
|-------------------------|----------------------|----------------------|--------------------------|
| | February 28, 2007 | February 28, 2006 | % Increase (Decrease) |
| Underwriting | \$ 155,256 | 131,400 | 18.2% |
| Advisory and other fees | 161,187 | 134,992 | 19.4% |
| Merchant banking | 33,736 | 71,461 | (52.8%) |
| Total investment | | | |
| banking | \$ 350,179 | \$ 337,853 | 3.6% |

Investment banking revenues increased 3.6% to \$350.2 million for the 2007 quarter from \$337.9 million for the 2006 quarter. Underwriting revenues increased 18.2% to \$155.3 million for the 2007 quarter from \$131.4 million for the corresponding prior year quarter. Equity underwriting revenues rose, reflecting increased volumes of lead and co-managed IPO and follow-on offerings as a result of improved global equity market conditions and increased market share. High grade underwriting revenues also increased on higher new issue volumes. These increases were partially offset by a decrease in high yield revenues. Advisory and other fees for the 2007 quarter increased 19.4% to \$161.2 million from \$135.0 million for the prior year quarter, reflecting increased M&A fees due to an increase in completed M&A assignments as well as an increase in fee income from mortgage servicing. Merchant banking revenues decreased to \$33.7 million in the 2007 quarter from \$71.5 million during the 2006 quarter, reflecting lower gains on the Company's portfolio of investments and lower performance fees on managed merchant banking funds.

Net interest revenues (interest and dividends revenue less interest expense) increased 26.0% to \$341.2 million for the 2007 quarter from \$270.8 million for the 2006 quarter. The increase in net interest revenues was primarily attributable to higher average customer margin debt balances and customer short balances. Average customer margin debt balances increased 26.0% to \$81.3 billion for the 2007 quarter from \$64.5 billion for the prior year quarter. Average customer short balances increased 20.2% to \$94.0 billion for the 2007 quarter from \$78.2 billion for the 2006 quarter and average securities borrowed balances increased 13.2% to \$59.9 billion for the 2007 quarter from \$52.9 billion for the 2006 quarter.

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Asset management and other revenues increased 19.5% to \$167.3 million for the 2007 quarter from \$140.1 million for the 2006 quarter, reflecting growth in management fees and performance fees on higher levels of traditional and alternative assets under management as well as improved investment returns on proprietary investments. Private Client Services net revenues also increased due to higher levels of fee-based assets.

Non-Interest Expenses

The Company's non-interest expenses were as follows:

| (in thousands) | Three Months Ended | | |
|----------------|----------------------|----------------------|--------------------------|
| | February 28, 2007 | February 28, 2006 | % Increase (Decrease) |

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| | | | |
|--|--------------|--------------|--------|
| Employee compensation and benefits | \$ 1,204,094 | \$ 1,046,850 | 15.0% |
| Floor brokerage, exchange and clearance fees | 56,085 | 51,243 | 9.4% |
| Communications and technology | 127,908 | 104,034 | 22.9% |
| Occupancy | 56,745 | 44,627 | 27.2% |
| Advertising and market development | 37,073 | 34,673 | 6.9% |
| Professional fees | 71,866 | 53,873 | 33.4% |
| Other expenses | 92,795 | 97,550 | (4.9%) |
| ----- | | | |
| Total non-interest expenses | \$ 1,646,566 | \$ 1,432,850 | 14.9% |
| ===== | | | |

Employee compensation and benefits includes the cost of salaries, benefits and incentive compensation, including Capital Accumulation Plan ("CAP Plan") units, restricted stock units and option awards. Employee compensation and benefits increased 15.0% to \$1.20 billion for the 2007 quarter from \$1.05 billion for the 2006 quarter, primarily due to higher discretionary compensation associated with the increase in net revenues and increased headcount. Employee compensation and benefits as a percentage of net revenues increased to 48.5% for the 2007 quarter from 47.9% for the 2006 quarter. Full-time employees increased to 14,409 at February 28, 2007 from 12,061 at February 28, 2006. The growth in headcount is primarily due to the expansion of the Company's domestic and international businesses, resulting from increased business activities and growth initiatives including acquisitions.

Non-compensation expenses increased 14.6% to \$442.5 million for the 2007 quarter from \$386.0 million for the 2006 quarter. Non-compensation expenses as a percentage of net revenues increased slightly to 17.8% for the 2007 quarter compared with 17.7% for the corresponding prior year quarter. Communications and technology costs increased 22.9% as increased headcount resulted in higher voice and market data-related costs. Occupancy costs increased 27.2% reflecting additional office space requirements and higher leasing costs associated with the Company's headquarters building at 383 Madison Avenue in New York City. Professional fees increased 33.4% due to higher levels of employment agency and consulting fees. CAP Plan related costs increased to \$41.5 million for the 2007 quarter from \$36.0 million in the comparable prior year quarter, due to a higher level of earnings. The Company achieved a pre-tax profit margin of 33.7% for the 2007 quarter, down from 34.4% in the 2006 quarter.

The Company's effective tax rate increased to 33.7% for the 2007 quarter from 31.7% for the 2006 quarter.

Business Segments

The remainder of "Results of Operations" is presented on a business segment basis. The Company's three business segments--Capital Markets, Global Clearing Services and Wealth Management--are analyzed separately due to the distinct nature of the products they provide and the clients they serve. Certain Capital Markets products are distributed by the Wealth Management and Global Clearing Services distribution networks, with the related revenues of such intersegment services allocated to the respective segments. See Note 12, "Segment Data" in the Notes to Condensed Consolidated Financial Statements for complete segment information.

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Capital Markets

| (in thousands) | Three Months Ended | | |
|------------------------|----------------------|----------------------|----------|
| | February 28, 2007 | February 28, 2006 | % |
| | | | Increase |
| Net revenues | | | |
| Institutional equities | \$ 512,653 | \$ 499,893 | 2.6% |
| Fixed income | 1,149,352 | 907,138 | 26.7% |
| Investment banking | 303,109 | 295,550 | 2.6% |
| Total net revenues | | | |
| | \$ 1,965,114 | \$ 1,702,581 | 15.4% |
| Pre-tax income | | | |
| | \$ 736,311 | \$ 652,327 | 12.9% |
| | | | |

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

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

Institutional equities consists of sales, trading and research, in areas such as domestic and international equities, block trading, over-the-counter equities, equity derivatives, energy and commodity activities, risk and convertible arbitrage and, through a majority-owned joint venture, specialist activities on the NYSE, American Stock Exchange ("AMEX") and International Securities Exchange ("ISE"). Fixed income includes sales, trading, origination and research provided to institutional clients across a variety of products such as mortgage- and asset-backed securities, corporate and government bonds, municipal bonds, high yield products, including bank and bridge loans, foreign exchange and interest rate and credit derivatives. Investment banking provides services in capital raising, strategic advice, mergers and acquisitions and merchant banking. Capital raising encompasses the Company's underwriting of equity, investment grade, municipal and high yield debt products.

Net revenues for Capital Markets increased 15.4% to \$1.97 billion for the 2007 quarter compared with \$1.70 billion for the 2006 quarter. Pre-tax income for Capital Markets increased 12.9% to \$736.3 million for the 2007 quarter from \$652.3 million for the comparable prior year quarter. Pre-tax profit margin was 37.5% for the 2007 quarter compared with 38.3% for the 2006 quarter.

Institutional equities net revenues for the 2007 quarter increased 2.6% to \$512.7 million from \$499.9 million for the comparable prior year quarter. Structured equity products net revenues achieved record levels due to increased customer activities and improved market conditions. Net revenues from the Company's international equity sales and trading area rose, reflecting higher trading volumes and increased market share. In addition, net revenues from the risk arbitrage business increased to record levels on higher global announced M&A volumes. Partially offsetting these increases, was a decrease in revenues from specialist activities and revenues from the Company's energy and commodity activities.

Fixed income net revenues increased 26.7% to \$1.15 billion for the 2007 quarter

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from \$907.1 million for the comparable prior year quarter. Net revenues from credit derivatives and distressed trading reached record levels during the 2007 quarter as corporate credit spreads tightened and customer activity levels remained robust. Interest rate derivatives also increased in the 2007 quarter compared with the 2006 quarter, primarily attributable to higher interest rate volatility and increased customer volumes. Despite strong trading volumes during the 2007 quarter the challenging market conditions in the subprime mortgage sector resulted in a decrease in mortgage-backed securities revenues when compared to the 2006 quarter. While subprime activities have historically represented only a small portion of the Company's mortgage activities, investor concerns over the direction of the delinquencies served to temporarily reduce liquidity in other sectors of the MBS market.

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Investment banking revenues increased 2.6% to \$303.1 million for the 2007 quarter from \$295.6 million for the 2006 quarter. Underwriting revenues increased 26.5% to \$172.2 million for the 2007 quarter from \$136.1 million for the corresponding prior year quarter, as equity and high grade underwriting revenues increased, reflecting increased new issue volumes, partially offset by a decrease in high yield underwriting. Advisory and other fees for the 2007 quarter increased 10.5% to \$97.2 million from \$88.0 million for the prior year quarter reflecting increased M&A fees due to an increase in completed M&A assignments during the quarter. Merchant banking revenues decreased to \$33.7 million in the 2007 quarter from \$71.5 million during the 2006 quarter, reflecting lower gains on the Company's portfolio of investments and lower performance fees on managed merchant banking funds.

Global Clearing Services

| (in thousands) | Three Months Ended | | |
|----------------|----------------------|----------------------|--------------------------|
| | February 28, 2007 | February 28, 2006 | % Increase (Decrease) |
| Net revenues | \$ 275,558 | \$ 263,425 | 4.6% |
| Pre-tax income | \$ 112,800 | \$ 124,859 | (9.7%) |

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

The Global Clearing Services segment provides execution, clearing, margin lending and securities borrowing to facilitate customer short sales to clearing clients worldwide. Prime brokerage clients include hedge funds and clients of money managers, short sellers, arbitrageurs and other professional investors. Fully disclosed clients engage in either the retail or institutional brokerage business. At February 28, 2007 and 2006, the Company held approximately \$298.0 billion and \$276.0 billion, respectively, in equity in Global Clearing Services client accounts.

Net revenues for Global Clearing Services increased 4.6% to \$275.6 million for the 2007 quarter from \$263.4 million in the 2006 quarter. Net interest revenues increased 7.2% to a record \$212.2 million for the 2007 quarter from \$198.0 million for the prior year quarter, on record levels of prime broker margin debt and customer short balances. Commissions and other revenues decreased 3.1% to \$63.4 million for the 2007 quarter from \$65.4 million for the comparable prior

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year quarter reflecting lower trading volumes from fully-disclosed clients and lower average rates from prime brokers. Pre-tax income decreased 9.7% to \$112.8 million, from \$124.9 million for the 2006 quarter.

The following table presents the Company's interest-bearing balances for the fiscal quarters ended:

| (in billions) | February 28, 2007 | February 28, 2006 |
|--|----------------------|----------------------|
| Margin debt balances, average for period | \$ 81.3 | \$ 64.5 |
| Margin debt balances, at period end | 86.6 | 64.5 |
| Customer short balances, average for period | 94.0 | 78.2 |
| Customer short balances, at period end | 95.1 | 78.1 |
| Securities borrowed, average for period | 59.9 | 52.9 |
| Securities borrowed, at period end | 59.4 | 52.4 |
| Free credit balances, average for period | 33.8 | 29.9 |
| Free credit balances, at period end | 37.1 | 30.6 |
| Equity held in client accounts | 298.0 | 276.0 |

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Wealth Management

| (in thousands) | Three Months Ended | | |
|---|----------------------|----------------------|------------|
| | February 28, 2007 | February 28, 2006 | % Increase |
| Private client services revenues | \$ 165,589 | \$ 153,895 | 7.6% |
| Revenue transferred to Capital Markets segment | (29,436) | (24,284) | 21.2% |
| Private client services net revenues | 136,153 | 129,611 | 5.0% |
| Asset management | 119,159 | 95,076 | 25.3% |
| Total net revenues | \$ 255,312 | \$ 224,687 | 13.6% |
| Pre-tax income | \$ 43,753 | \$ 31,786 | 37.6% |

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

The Wealth Management segment is composed of the PCS and asset management areas.

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PCS provides high-net-worth individuals with an institutional level of investment service, including access to the Company's resources and professionals. At February 28, 2007, PCS has approximately 500 account executives in its principal office, six regional offices and two international offices. Asset management manages equity, fixed income and alternative assets for corporate pension plans, public systems, endowments, foundations, multi-employer plans, insurance companies, corporations, families and high-net-worth individuals in the United States and abroad.

Net revenues for Wealth Management increased 13.6% to \$255.3 million for the 2007 quarter from \$224.7 million for the 2006 quarter. PCS revenues increased 5.0% to \$136.2 million for the 2007 quarter from \$129.6 million for the 2006 quarter reflecting higher levels of fee-based income. Asset management revenues increased 25.3% to \$119.2 million for the 2007 quarter from \$95.1 million for the 2006 quarter. This increase reflects increased performance fees and growth in management fees on traditional and alternative assets under management. Pre-tax income for Wealth Management increased 37.6% to \$43.8 million in the 2007 quarter from \$31.8 million for the 2006 quarter.

Assets under management were \$54.1 billion at February 28, 2007, reflecting a 19.2% increase from \$45.4 billion in assets under management at February 28, 2006. The increase in assets under management is due to the growth in traditional equity assets and hedge funds. Assets under management at February 28, 2007 includes \$8.7 billion of assets from alternative investment products, an increase from \$7.0 billion at February 28, 2006.

LIQUIDITY AND CAPITAL RESOURCES

Financial Leverage

Asset Composition

The Company's actual level of capital, capital requirements and thereby the level of financial leverage, is a function of numerous variables, including asset composition, rating agency/creditor perception, business prospects, regulatory requirements, balance sheet liquidity, cost/availability of capital and risk of loss. The Company consistently maintains a highly liquid balance sheet, with the vast majority of the Company's assets consisting of cash, marketable securities inventories and collateralized receivables arising from customer-related and proprietary securities transactions.

Collateralized receivables consist of resale agreements secured predominantly by US government and agency securities, customer margin loans and securities borrowed, which are typically secured by marketable corporate debt and equity securities. The nature of the Company's business as a securities dealer requires it to carry significant levels of securities inventories to meet its customer and proprietary trading needs. Additionally, the Company's role as a financial intermediary for customer activities, which it conducts on a principal basis, together with its customer-related activities in its clearance business, results in significant levels of customer-related balances, including customer margin debt, securities borrowed and

reverse repurchase activity. The Company's total assets and financial leverage can and do fluctuate, depending largely on economic and market conditions, volume of activity and customer demand.

The Company's total assets at February 28, 2007 increased to \$394.5 billion from \$350.4 billion at November 30, 2006. The increase was primarily attributable to

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increases in financial instruments owned, assets of variable interest entities and mortgage loan special purpose entities, securities borrowed, and customer receivables partially offset by a decrease in securities purchased under agreements to resell. The Company's total capital base, which consists of long-term debt, preferred equity issued by subsidiaries and total stockholders' equity, increased to \$71.8 billion at February 28, 2007 from \$66.7 billion at November 30, 2006. This change was primarily due to a net increase in long-term debt and an increase in stockholders' equity primarily due to earnings in the February 2007 quarter as well as income tax benefits attributable to the distribution of common stock under the Company's deferred compensation plans.

The Company's total capital base as of February 28, 2007 and November 30, 2006 was as follows:

| (in millions) | February 28, 2007 | November 30, 2006 |
|--------------------------------|----------------------|----------------------|
| ----- | | |
| Long-term borrowings: | | |
| Senior debt | \$ 57,232.0 | \$ 53,307.4 |
| Subordinated debt (1) | 1,262.5 | 1,262.5 |
| ----- | | |
| Total long-term borrowings | \$ 58,494.5 | \$ 54,569.9 |
| Stockholders' equity: | | |
| Preferred stockholders' equity | \$ 359.2 | \$ 359.2 |
| Common stockholders' equity | 12,914.7 | 11,770.2 |
| ----- | | |
| Total stockholders' equity | \$ 13,273.9 | \$ 12,129.4 |
| ----- | | |
| Total capital | \$ 71,768.4 | \$ 66,699.3 |
| ===== | | |

(1) Includes \$1.0 billion in subordinated debt issued by the Company and \$262.5 million in junior subordinated deferrable interest debentures ("Debentures") issued by the Company and held by Bear Stearns Capital Trust III ("Capital Trust III") at February 28, 2007 and November 30, 2006.

The amount of long-term debt as well as total capital that the Company maintains is driven by a number of factors, with particular focus on asset composition. The Company's ability to support increases in total assets is a function of its ability to obtain short-term secured and unsecured funding, as well as its access to longer-term sources of capital (i.e., long-term debt and equity). The Company regularly measures and monitors its total capital requirements, which are primarily a function of the self-funding ability of its assets. The equity portion of total capital is primarily a function of on- and off-balance-sheet risks (i.e., market, credit and liquidity) and regulatory capital requirements. As such, the liquidity and risk characteristics of assets being held are critical determinants of both total capital and the equity portion thereof, thus significantly influencing the amount of leverage that the Company can employ.

Given the nature of the Company's market-making and customer-financing activity, the overall size of the balance sheet fluctuates from time to time. The Company's total assets at each quarter end are typically lower than would be observed on an average basis. At the end of each quarter, the Company typically uses excess cash to finance high-quality, highly liquid securities inventory that otherwise would be funded via the repurchase agreement market. In addition, the Company reduces its matched book repurchase and reverse repurchase activities at quarter end. Finally, the Company may reduce the aggregate level of inventories through ordinary course, open market activities in the most liquid portions of the balance sheet, which are principally US government and agency securities and agency mortgage pass-through securities. At February 28,

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2007, total assets of \$394.5 billion were approximately 5.6% higher than the average of the month-end balances observed over the trailing 12-month period, while total assets at November 30, 2006 were approximately 0.5% higher than the average of the same time period in the prior year. Despite reduced total assets at each quarter end, the Company's overall market, credit and liquidity risk profile does not change materially, since the reduction in asset balances is predominantly in highly liquid, short-term instruments that are financed on a secured basis. This periodic reduction verifies the inherently liquid nature of the balance sheet and provides consistency with respect to creditor constituents' evaluation of the Company's financial condition.

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Leverage Ratios

Balance sheet leverage measures are one approach to assessing the capital adequacy of a securities firm, such as the Company. Gross leverage equals total assets divided by stockholders' equity, inclusive of preferred and trust preferred equity. The Company views its trust preferred equity as a component of its equity capital base given the equity-like characteristics of the securities. The Company also receives rating agency equity credit for these securities. Net adjusted leverage equals net adjusted assets divided by tangible equity capital, which excludes goodwill and intangible assets from both the numerator and the denominator, as equity used to support goodwill and intangible assets is not available to support the balance of the Company's net assets. With respect to a comparative measure of financial risk and capital adequacy, the Company believes that the low-risk nature of the items excluded in deriving net adjusted assets (see table) renders net adjusted leverage as the relevant measure.

| (in millions, except ratios) | February 28, 2007 | November 30, 2006 |
|---|----------------------|----------------------|
| | | |
| Total assets | \$ 394,512 | \$ 350,433 |
| Deduct: | | |
| Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations | 9,126 | 8,804 |
| Securities purchased under agreements to resell | 37,248 | 38,838 |
| Securities received as collateral | 21,227 | 19,648 |
| Securities borrowed | 84,015 | 80,523 |
| Receivables from customers | 32,530 | 29,482 |
| Assets of variable interest entities and Mortgage loan special purpose entities, net | 39,649 | 29,080 |
| Goodwill & intangible assets | 422 | 383 |
| Subtotal | 170,295 | 143,675 |
| Add: | | |
| Financial instruments sold, but not yet purchased | 42,279 | 42,256 |
| Deduct: | | |
| Derivative financial instruments sold, but not yet purchased | 10,135 | 11,865 |
| | | |

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| | | | | |
|------------------------------|----|---------|----|---------|
| Net adjusted assets | \$ | 202,439 | \$ | 174,066 |
| ===== | | | | |
| Stockholders' equity | | | | |
| Common equity | \$ | 12,915 | \$ | 11,770 |
| Preferred stock | | 359 | | 359 |
| Stock-based compensation | | -- | | 816(1) |
| ----- | | | | |
| Total stockholders' equity | | 13,274 | | 12,945 |
| ----- | | | | |
| Add: | | | | |
| Trust preferred equity | | 263 | | 263 |
| ----- | | | | |
| Subtotal - leverage equity | | 13,537 | | 13,208 |
| ----- | | | | |
| Deduct: | | | | |
| Goodwill & intangible assets | | 422 | | 383 |
| ----- | | | | |
| Tangible equity capital | \$ | 13,115 | \$ | 12,825 |
| ===== | | | | |
| Gross leverage | | 29.1x | | 26.5x |
| Net adjusted leverage | | 15.4x | | 13.6x |
| ----- | | | | |

(1) Represents stock-based compensation associated with fiscal 2006 awards that was reflected in equity as of the grant date in December 2006, in accordance with SFAS No. 123(R), "Share-based Payment." Excluding this adjustment for stock-based compensation, gross leverage and net adjusted leverage at November 30, 2006 would have been 28.3x and 14.5x, respectively.

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Funding Strategy & Liquidity Risk Management

General Funding Strategy

Liquidity is extraordinarily important for financial services firms in general and for securities firms such as the Company in particular, given their reliance on market confidence. The Company's overall objective and general funding strategy seeks to ensure liquidity and diversity of funding sources to meet the Company's financing needs at all times and under all market environments. In financing its balance sheet, the Company attempts to maximize its use of secured funding where economically competitive. Short-term sources of cash consist principally of collateralized borrowings, including repurchase transactions, sell/buy arrangements, securities lending arrangements and customer free credit balances. Short-term unsecured funding sources expose the Company to rollover risk, as providers of credit are not obligated to refinance the instruments at maturity. For this reason, the Company seeks to prudently manage its reliance on short-term unsecured borrowings by maintaining an adequate total capital base and extensive use of secured funding. In addition to this strategy, the Company places emphasis on diversification by product, geography, maturity and instrument in order to further ensure prudent, moderate usage of more credit-sensitive, potentially less stable, funding. Short-term unsecured funding sources include commercial paper, medium-term notes and bank borrowings, which generally have maturities ranging from overnight to one year. The Company views its secured funding as inherently less credit sensitive and therefore a more stable source of funding due to the collateralized nature of the borrowing.

In addition to short-term funding sources, the Company utilizes equity and

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long-term debt, including floating- and fixed-rate notes, as longer-term sources of unsecured financing. The Company regularly monitors and analyzes the size, composition and liquidity characteristics of its asset base in the context of each asset's ability to be used to obtain secured financing. This analysis helps the Company in determining its aggregate need for longer-term funding sources (i.e., long-term debt and equity). The Company views long-term debt as a stable source of funding, which effectively strengthens its overall liquidity profile and mitigates liquidity risk.

Alternative Funding Strategy

The Company maintains an alternative funding strategy focused on the liquidity and self-funding ability of the underlying assets. The objective of this strategy is to maintain sufficient cash capital (i.e., equity plus long-term debt maturing in more than 12 months) and funding sources to enable the Company to refinance short-term, unsecured borrowings with fully secured borrowings. As such, the Company is not reliant upon nor does it contemplate forced balance sheet reduction to endure a period of constrained funding availability. This underlying approach is supported by maintenance of a formal contingency funding plan, which includes a detailed delegation of authority and precise action steps for managing an event-driven liquidity crisis. The plan identifies the crisis management team, details an effective internal and external communication strategy, and facilitates the greater information flow required to effect a rapid and efficient transition to a secured funding environment.

As it relates to the alternative funding strategy discussed above, the Company prepares an analysis that focuses on a 12-month time period and assumes that the Company does not liquidate assets and cannot issue any new unsecured debt, including commercial paper. Under these assumptions, the Company monitors its cash position and the borrowing value of unencumbered, unencumbered financial instruments in relation to its unsecured debt maturing over the next 12 months, striving to maintain the ratio of liquidity sources to maturing debt at 110% or greater. Also within this strategy, the Company seeks to maintain cash capital in excess of that portion of its assets that cannot be funded on a secured basis (i.e., positive net cash capital). These two measures, liquidity ratio and net cash capital, are complementary and constitute the core elements of the Company's alternative funding strategy and, consequently, its approach to funding and liquidity risk management.

The borrowing value advance rates used in the Company's liquidity ratio calculation and the haircuts incorporated in the cash capital model are symmetrical. These advance rates are considered readily available, even in a stress environment. In the vast majority of circumstances/asset classes, advance rates are derived from committed secured bank facilities, whereby a bank or group of banks are contractually obligated to lend to the Company at a pre-specified advance rate on specific types of collateral regardless of "market environment." As such, the advance rates/haircuts in the alternative liquidity models are

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typically worse than those the Company realizes in normalized repo and secured lending markets. The advance rates in the liquidity ratio reflect what can be reliably realized in a stressed liquidity environment. The haircuts used in the cash capital model are consistent with the advance rates used in the liquidity ratio in that the haircut is equal to one minus the advance rate.

As of February 28, 2007, the market value of unencumbered, unencumbered financial instruments owned by the Company was approximately \$48.3 billion with a borrowing value of \$38.0 billion. The assets are primarily comprised of

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mortgage- and asset-backed securities, investment grade municipal and corporate bonds, US equities and residential and commercial mortgage whole loans. The average advance rate on these different asset types ranges from 58% to 98% and, as described above, is based predominantly on committed, secured facilities that the Company and its subsidiaries maintain in different regions globally. The liquidity ratio, explained above, based solely on Company-owned securities, has averaged 125% over the previous 12 months, including the Company's \$4.0 billion unused committed unsecured bank credit, and 119%, excluding the committed unsecured revolving credit facility. On this same basis, the liquidity ratio as of February 28, 2007 was 149% and 136%, respectively.

While The Bear Stearns Companies Inc. ("Parent Company") is the primary issuer of unsecured debt in the marketplace, the collateral referred to in the preceding paragraph is held in various subsidiaries, both regulated and unregulated. A subsidiary's legal entity status and the Company's intercompany funding structure may constrain liquidity available to the Parent Company, as regulators may prevent the flow of funds and/or securities from a regulated subsidiary to its parent company or other subsidiaries. In recognition of this potential for liquidity to be trapped in subsidiaries, the Company maintains a minimum of \$5.0 billion of liquidity immediately accessible by the Parent Company at all times. This liquidity reserve takes the form of cash deposits and money market instruments that are held at the Parent Company and high-quality collateral (corporate bonds, municipal bonds, equity securities) that is owned by subsidiaries and explicitly pledged to and segregated for the benefit of the Parent Company and maintained at a third-party custodian. For purposes of calculating the aggregate value of the liquidity reserve, the contractually obligated advance rates described herein are used to determine the borrowing value of collateral pledged. In addition to this immediately available liquidity, the Company monitors unrestricted liquidity available to the Parent Company via the ability to monetize unencumbered assets held in unregulated and regulated entities. As of February 28, 2007, approximately \$28.1 billion of the market value identified in the liquidity ratio data above was held in unregulated entities and thus likely to be available to the Parent Company, while an additional \$4.0 billion market value had been pledged to the Parent Company as collateral for inter-company borrowings and was thus readily available. The remaining \$16.2 billion market value of unencumbered securities was held in regulated entities, a portion of which may not be available to provide liquidity to the Parent Company.

The cash capital framework is utilized to evaluate the Company's long-term funding sources and requirements in their entirety. Cash capital required to support all of the Company's assets is determined on a regular basis. For purposes of broadly classifying the drivers of cash capital requirements, cash capital usage can be delineated across two very broad categories as (1) firmwide haircuts and (2) illiquid assets/long-term investments. More precisely, the Company holds cash capital to support longer-term funding requirements, including, but not limited to, the following:

- o That portion of financial instruments owned that cannot be funded on a secured basis (i.e., the haircuts);
- o Margin loans and resale principal in excess of the borrowing value of collateral received;
- o Operational cash deposits required to support the regular activities of the Company (e.g., exchange initial margin);
- o Unfunded committed funding obligations, such as corporate loan commitments;
- o Less liquid and illiquid assets, such as goodwill and fixed assets;
- o Uncollateralized funded loans and funded loans secured by illiquid and/or non-rehypothecatable collateral;
- o Merchant banking assets and other long-term investments; and
- o Regulatory capital in excess of a regulated entity's cash capital based longer-term funding requirements.

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At February 28, 2007, the Company's net cash capital position was \$5.4 billion. Fluctuations in net cash capital are common and are a function of variability in total assets, balance sheet composition and total capital. The Company attempts to maintain cash capital sources in excess of the aggregate longer-term funding requirements of the firm (i.e., positive net cash capital). Over the previous 12 months, the Company's total cash capital requirement, cash capital intensity ratio (average

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haircut), and net cash capital position have averaged \$57.4 billion, 15.9% and \$1.2 billion, respectively.

In addition to the alternative funding measures above, the Company monitors the maturity profile of its unsecured debt to minimize refinancing risk, maintains relationships with a broad global base of debt investors and bank creditors, establishes and adheres to strict short-term debt investor concentration limits, and periodically tests its secured and unsecured committed credit facilities. An important component of the Company's funding and liquidity risk management efforts involves ongoing dialogues with a large number of creditor constituents. Strong relationships with a diverse base of creditors and debt investors are crucial to the Company's liquidity. The Company also maintains available sources of short-term funding that exceed actual utilization, thus allowing it to endure changes in investor appetite and credit capacity to hold the Company's debt obligations.

With respect to the management of refinancing risk, the maturity profile of the long-term debt portfolio of the Company is monitored on an ongoing basis and structured within the context of two diversification guidelines. The Company has a general guideline of no more than 20% of its long-term debt portfolio maturing in any one year, as well as no more than 10% maturing in any one quarter over the next five years. The Company continued to meet these guidelines at the end of the quarter ended February 28, 2007. As of February 28, 2007, the weighted average maturity of the Company's long-term debt was 4.4 years.

Committed Credit Facilities

The Company has a committed revolving credit facility ("Facility") totaling \$4.0 billion, which permits borrowing on a secured basis by the Parent Company, BSSC, BSIL and certain other subsidiaries. The Facility also allows the Parent Company, BSIL and Bear Stearns International Trading Limited ("BSIT") to borrow up to \$4.0 billion of the Facility on an unsecured basis. Secured borrowings can be collateralized by both investment-grade and non-investment-grade financial instruments as the Facility provides for defined advance rates on a wide range of financial instruments eligible to be pledged. The Facility contains financial covenants, the most significant of which require maintenance of specified levels of stockholders' equity of the Company and net capital of BSSC. The Facility terminates in February 2008, with all loans outstanding at that date payable no later than February 2009. There were no borrowings outstanding under the Facility at February 28, 2007.

The Company has a \$1.5 billion committed revolving securities repo facility ("Repo Facility"), which permits borrowings secured by a broad range of collateral under a repurchase arrangement by the Parent Company, BSIL, BSIT and BSB. The Repo Facility contains financial covenants that require, among other things, maintenance of specified levels of stockholders' equity of the Company. The Repo Facility terminates in August 2007, with all repos outstanding at that date payable no later than August 2008. There were no borrowings outstanding under the Repo Facility at February 28, 2007.

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The Company has a \$350 million committed revolving credit facility ("Pan Asian Facility"), which permits borrowing on a secured basis by the Parent Company, BSSC, Bear Stearns Japan Limited ("BSJL"), and BSIL. The Pan Asian Facility contains financial covenants that require, among other things, maintenance of specified levels of stockholders' equity of the Company and net capital of BSSC. The Pan Asian Facility terminates in December 2007 with all loans outstanding at that date payable no later than December 2008. There were no borrowings outstanding under the Pan Asian Facility at February 28, 2007.

The Company has a \$350 million committed revolving credit facility ("Tax Lien Facility"), which permits borrowing on a secured basis by the Parent Company, Plymouth Park Tax Services and Madison Tax Capital LLC. The Tax Lien Facility contains financial covenants that require, among other things, maintenance of specified levels of stockholders' equity of the Company. In March 2007, the Company renewed the Tax Lien Facility at a \$450 million committed level with substantially the same terms. The Tax Lien Facility terminates in March 2008 with all loans outstanding at that date payable no later than March 2009. There were no borrowings outstanding under the Tax Lien Facility at February 28, 2007.

The Company also maintains a series of committed credit facilities, which permit borrowing on a secured basis, to support liquidity needs for the financing of investment-grade and non-investment-grade corporate loans, residential mortgages,

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commercial mortgages, listed options and whole loans. The facilities are expected to be drawn from time to time and expire at various dates, the longest of such periods ending in fiscal 2008. All of these facilities contain a term-out option of one year or more for borrowings outstanding at expiration. The banks providing these facilities are committed to provide up to an aggregate of approximately \$4.7 billion. At February 28, 2007, the borrowings outstanding under these committed credit facilities were \$435.8 million.

Capital Resources

The Parent Company, operating as the centralized unsecured funding arm of the Company, raises the vast majority of the Company's unsecured debt, including both commercial paper and long-term debt. The Parent Company is thus the "central bank" of the Company, where all capital is held and from which capital is deployed. The Parent Company advances funds in the form of debt or equity to subsidiaries to meet their operating funding needs and regulatory capital requirements. In addition to the primary regulated subsidiaries, the Company also conducts significant activities through other wholly owned subsidiaries, including: Bear Stearns Global Lending Limited, Custodial Trust Company, Bear Stearns Financial Products Inc., Bear Stearns Capital Markets Inc., Bear Stearns Credit Products Inc., Bear Stearns Forex Inc., EMC Mortgage Corporation and Bear Stearns Commercial Mortgage, Inc. and through its majority owned subsidiary Bear Hunter Holdings LLC. In connection with all of the Company's operating activities, a substantial portion of the Company's long-term borrowings and equity has been used to fund investments in, and advances to, these subsidiaries, including subordinated debt advances.

Within this funding framework, the Company attempts to fund equity investments in subsidiaries with equity from the Parent Company (i.e., utilize no equity double leverage). At February 28, 2007, the Parent Company's equity investment in subsidiaries was \$8.4 billion versus common stockholders' equity and preferred equity of \$12.9 billion and \$359.2 million, respectively. As such, at February 28, 2007, the ratio of the equity investment in subsidiaries to Parent

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Company equity (equity double leverage) was approximately 0.65 based on common equity and 0.63 including preferred equity. At November 30, 2006, these measures were 0.67 based on common equity and 0.65 including preferred equity. Additionally, all subordinated debt advances to regulated subsidiaries for use as regulatory capital, which totaled \$10.5 billion at February 28, 2007, are funded with long-term debt issued by the Company, having a remaining maturity equal to or greater than the maturity of the subordinated debt advance. The Company regularly monitors the nature and significance of assets or activities conducted in all subsidiaries and attempts to fund such assets with both capital and/or borrowings having a maturity profile and relative mix consistent with the nature and self-funding ability of the assets being financed. The funding mix also takes into account regulatory capital requirements for regulated subsidiaries.

Long-term debt totaling \$52.3 billion and \$48.1 billion had remaining maturities beyond one year at February 28, 2007 and November 30, 2006, respectively. The Company accesses funding in a variety of markets in the United States, Europe and Asia. The Company issues debt through syndicated US registered offerings, US-registered and 144A medium-term note programs, other US and non-US bond and note offerings and other methods. The Company's access to external sources of financing, as well as the cost of that financing, is dependent on various factors and could be adversely affected by a deterioration of the Company's long- and short-term debt ratings, which are influenced by a number of factors. These include, but are not limited to: material changes in operating margins; earnings trends and volatility; the prudence of funding and liquidity management practices; financial leverage on an absolute basis or relative to peers; the composition of the balance sheet and/or capital structure; geographic and business diversification; and the Company's market share and competitive position in the business segments in which it operates. Material deterioration in any one or a combination of these factors could result in a downgrade of the Company's credit ratings, thus increasing the cost of and/or limiting the availability of unsecured financing. Additionally, a reduction in the Company's credit ratings could also trigger incremental collateral requirements, predominantly in the over-the-counter derivatives market. As of February 28, 2007, a downgrade by either Moody's Investors Service or Standard & Poor's in the Company's long-term credit ratings to the level of A2 or A (i.e., one notch) would have resulted in the Company being required to post \$18.8 million in additional collateral pursuant to contractual arrangements for outstanding over-the-counter derivatives contracts. A downgrade to A3 or A- (i.e., two notches) would have resulted in the Company being required to post an additional \$45.4 million in collateral.

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At February 28, 2007, the Company's long-term/short-term debt ratings were as follows:

| | Long-Term Rating | Short-Term Rating |
|--------------------------------------|---------------------|----------------------|
| ----- | ----- | ----- |
| Dominion Bond Rating Service Limited | A (high) | R-1 (middle) |
| Fitch Ratings | A+ | F1+ |
| Japan Credit Rating Agency, Ltd. | AA | NR |
| Moody's Investors Service | A1 | P-1 |
| Rating & Investment | | |
| Information, Inc. | AA- | NR |
| Standard & Poor's Ratings Services | A+ | A-1 |
| ----- | | |

NR - does not assign a short-term rating

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In October 2006, Standard & Poor's Ratings Services ("S&P") upgraded The Bear Stearns Companies Inc. long-term rating to A+. In a press release, S&P stated that the rating change reflects the Company's relatively low profit volatility, conservative management and cost flexibility, as well as long-term improvements in its liquidity and risk management. In addition, in June 2006, Japan Credit Rating Agency, Ltd. assigned a rating of AA with a "Stable" outlook to the Company, while in August 2006, Rating and Investment Information, Inc. upgraded the Company to AA- from A+ with a "Stable" outlook.

Stock Repurchase Program

The Company has various employee stock compensation plans designed to increase the emphasis on stock-based incentive compensation and align the compensation of its key employees with the long-term interests of stockholders. Such plans provide for annual grants of stock units and stock options. The Company intends to offset the potentially dilutive impact of the annual grants by purchasing common stock throughout the year in open market and private transactions. On December 13, 2006, the Board of Directors of the Company approved an amendment to the Stock Repurchase Program ("Repurchase Program") to replenish the previous authorizations to allow the Company to purchase up to \$2.0 billion of common stock in fiscal 2007 and beyond. During the quarter ended February 28, 2007, the Company purchased under the current and prior authorizations a total of 2,634,388 shares at a cost of approximately \$431.7 million. Approximately \$1.58 billion was available to be purchased under the current authorization as of February 28, 2007. The Company expects to utilize the repurchase authorization to offset the dilutive impact of annual share awards. The Company may, depending on price and other factors, repurchase additional shares in excess of that required for annual share awards.

During the quarter ended February 28, 2007, the Company also purchased a total of 248,556 shares of its common stock at a total cost of \$41.5 million pursuant to a \$200 million CAP Plan Earnings Purchase Authorization, which was approved by the Compensation Committee of the Board of Directors of the Company on December 12, 2006.

Cash Flows

Cash and cash equivalents increased \$1.30 billion to \$5.89 billion at February 28, 2007 from \$4.60 billion at November 30, 2006. Cash used in operating activities was \$6.16 billion, primarily attributable to increases in financial instruments owned, receivables from customers and securities borrowed, net of securities loaned, partially offset by increases in securities sold under agreements to repurchase, net of securities purchased under agreements to resell and payables to customers which occurred in the normal course of business as a result of changes in customer needs, market conditions and trading strategies. Cash used in investing activities of \$67.3 million reflected purchases of property, equipment and leasehold improvements. Cash provided by financing activities of \$7.52 billion reflected net proceeds from the issuance of long-term borrowings of \$8.08 billion and net proceeds relating to short-term borrowings of \$3.17 billion, primarily to fund normal operating activities. This was partially offset by net payments for the retirement/repurchase of long-term borrowings of \$3.55 billion. Treasury stock purchases of \$473.2 million were made to provide for the annual grant of CAP Plan units, restricted stock and stock options.

Cash and cash equivalents decreased \$807.7 million to \$5.05 billion at February

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28, 2006 from \$5.86 billion at November 30, 2005. Cash used in operating activities was \$5.01 billion, primarily attributable to increases in securities borrowed, net of securities loaned and financial instruments owned, partially offset by an increase in securities sold under agreements to repurchase, net of securities purchased under agreements to resell which occurred in the normal course of business as a result of changes in customer needs, market conditions and trading strategies. Cash used in investing activities of \$39.2 million reflected purchases of property, equipment and leasehold improvements. Cash provided by financing activities of \$4.24 billion reflected net proceeds from the issuance of long-term borrowings of \$4.94 billion and net proceeds relating to short-term borrowings of \$1.56 billion, primarily to fund normal operating activities. This was partially offset by net payments for the retirement/repurchase of long-term borrowings of \$2.20 billion. Treasury stock purchases of \$476.4 million were made to provide for the annual grant of CAP Plan units, restricted stock and stock options.

Regulated Subsidiaries

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

As registered broker-dealers and futures commission merchants, Bear Stearns and BSSC are subject to the net capital requirements of the Exchange Act and Rule 1.17 under the Commodity Futures Trading Commission. Bear Stearns uses Appendix E of the Net Capital Rule which establishes alternative net capital requirements for broker-dealers that are part of consolidated supervised entities. Appendix E allows Bear Stearns to calculate net capital charges for market risk and derivatives-related credit risk based on mathematical models provided that Bear Stearns holds tentative net capital in excess of \$1 billion and net capital in excess of \$500 million. BSIL and BSIT, the Company's London-based broker-dealer subsidiaries, are subject to the regulatory capital requirements of the United Kingdom's Financial Services Authority. Additionally, BSB is subject to the regulatory capital requirements of the Financial Regulator. Custodial Trust Company ("CTC"), a Federal Deposit Insurance Corporation ("FDIC") insured New Jersey state chartered bank, is subject to the regulatory capital requirements of the FDIC. At February 28, 2007, Bear Stearns, BSSC, BSIL, BSIT, BSB and CTC were in compliance with their respective regulatory capital requirements. Certain other subsidiaries are subject to various securities regulations and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. At February 28, 2007, these other subsidiaries were in compliance with their applicable local capital adequacy requirements.

The Company's broker-dealer subsidiaries and other regulated subsidiaries are subject to minimum capital requirements and may also be subject to certain restrictions on the payment of dividends, which could limit the Company's ability to withdraw capital from such regulated subsidiaries, which in turn could limit the Company's ability to pay dividends. See Note 9, "Regulatory Requirements," in the Notes to Condensed Consolidated Financial Statements.

Merchant Banking and Private Equity Investments

In connection with the Company's merchant banking activities, the Company had investments in merchant banking and private equity-related investment funds as well as direct investments in private equity-related investments. At February 28, 2007, the Company held investments with an aggregate recorded fair value of approximately \$1.08 billion, reflected in the Condensed Consolidated Statements of Financial Condition in "Other assets." At November 30, 2006, the Company held investments with an aggregate recorded value of approximately \$822.4 million. In

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addition to these various direct and indirect principal investments, the Company has made commitments to invest in private equity-related investments and partnerships (see the summary table under "Commitments").

High Yield Positions

As part of its fixed income activities, the Company participates in the underwriting and trading of non-investment-grade corporate debt securities and also invests in, syndicates and trades in loans to highly leveraged, below investment grade rated

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

companies (collectively, "high yield positions"). Non-investment-grade debt securities have been defined as non-investment-grade corporate debt and emerging market debt rated BB+ or lower, or equivalent ratings recognized by credit rating agencies. At February 28, 2007 and November 30, 2006, the Company held high yield positions approximating \$9.96 billion and \$10.73 billion, respectively, substantially all of which are in "Financial instruments owned" in the Condensed Consolidated Statements of Financial Condition, and \$719.9 million and \$605.4 million, respectively, reflected in "Financial instruments sold, but not yet purchased" in the Condensed Consolidated Statements of Financial Condition. Included in the high yield positions are extensions of credit to highly leveraged companies. At February 28, 2007 and November 30, 2006, the amount outstanding to highly leveraged borrowers totaled \$6.60 billion and \$7.70 billion, respectively. The largest industry concentration was the telecommunications industry, which approximated 15.6% and 22.8% of these highly leveraged borrowers' positions at February 28, 2007 and November 30, 2006, respectively. Additionally, the Company has lending commitments with highly leveraged borrowers (see the summary table under "Commitments").

The Company's Risk Management Department and senior trading managers monitor exposure to market and credit risk for high yield positions and establish limits and concentrations of risk by individual issuer. High yield positions generally involve greater risk than investment grade debt securities due to credit considerations, liquidity of secondary trading markets and increased vulnerability to changes in general economic conditions. The level of the Company's high yield positions, and the impact of such activities on the Company's results of operations, can fluctuate from period to period as a result of customer demand, economic conditions and market considerations.

Contractual Obligations

In connection with its operating activities, the Company enters into contractual obligations that require future cash payments. At February 28, 2007, the Company's contractual obligations by maturity, excluding derivative financial instruments, were as follows:

| (in millions) | Payments Due By Period | | | |
|---------------|--------------------------|----------------------|----------------------|----------|
| | Remaining Fiscal 2007 | Fiscal 2008- 2009 | Fiscal 2010- 2011 | Thereaft |
| | | | | |

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| | | | | | | | | |
|---------------------------------------|----|-------|----|--------|----|--------|----|-----|
| Long-term borrowings (1) (2) | \$ | 4,050 | \$ | 20,246 | \$ | 14,357 | \$ | 19, |
| Future minimum lease payments (3) (4) | | 79 | | 211 | | 209 | | |

- (1) Amounts include hybrid debt issuances accounted for at fair value as elected under SFAS No. 155 and fair value adjustments in accordance with SFAS No. 133 as well as \$262.5 million of junior subordinated deferrable interest debentures ("Debentures"). The Debentures will mature on May 15, 2031; however, the Company, at its option, may redeem the Debentures beginning May 15, 2006. The Debentures are reflected in the table at their contractual maturity dates.
- (2) Included in fiscal 2008-2009 are approximately \$1.83 billion of floating-rate notes that are redeemable prior to maturity at the option of the noteholder. These notes contain certain provisions that effectively enable noteholders to put these notes back to the Company and, therefore, are reflected in the table at the date such notes first become redeemable. The final maturity dates of these notes are during fiscal 2010-2011.
- (3) Includes 383 Madison Avenue Headquarters in New York City.
- (4) See Note 10, "Commitments and Contingencies," in the Notes to Condensed Consolidated Financial Statements.

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MANAGEMENT'S DISCUSSION AND ANALYSIS
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Commitments

The Company has commitments(1) under a variety of commercial arrangements. At February 28, 2007 the Company's commitments associated with lending and financing, private equity-related investments and partnerships, outstanding letters of credit, underwriting and other commercial commitments summarized by period of expiration were as follows:

| (in millions) | Amount of Commitment Expiration | | | |
|--|---------------------------------|-------------------|-------------------|------------|
| | Remaining Fiscal 2007 | Fiscal 2008- 2009 | Fiscal 2010- 2011 | Thereafter |
| Lending-related commitments: | | | | |
| Investment-grade (2) | \$ 896 | \$ 634 | \$ 1,437 | \$ 265 |
| Non-investment-grade(2) | 281 | 305 | 945 | 606 |
| Contingent commitments | 5,467 | 1,004 | - | - |
| Commitments to invest in private equity-related investments and partnerships (3) | - | - | - | - |
| Underwriting commitments | 531 | - | - | - |
| Commercial and residential loans | 4,988 | 503 | 42 | 102 |

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| | | | | |
|------------------------------|-------|-----|----|---|
| Letters of credit | 3,917 | - | 34 | - |
| Other commercial commitments | 74 | 105 | 17 | - |

- (1) See Note 10, "Commitments and Contingencies," in the Notes to Condensed Consolidated Financial Statements.
- (2) In order to mitigate the exposure to investment-grade and non-investment-grade borrowings, the Company entered into credit default swaps approximating \$764.5 million and \$102.8 million, respectively, in notional value, at February 28, 2007.
- (3) These commitments will be funded, if called, through the end of the respective investment periods, the longest of such periods ending in 2017.

OFF-BALANCE-SHEET ARRANGEMENTS

In the normal course of business, the Company enters into arrangements with special purpose entities ("SPEs"), also known as variable interest entities ("VIEs"). SPEs are corporations, trusts or partnerships that are established for a limited purpose. SPEs, by their nature, are generally not controlled by their equity owners, as the establishing documents govern all material decisions. The Company's primary involvement with SPEs relates to securitization transactions in which transferred assets, including commercial and residential mortgages, consumer receivables, securities and other financial assets are sold to an SPE and repackaged into securities or similar beneficial interests. SPEs may also be used to create securities with a unique risk profile desired by investors and as a means of intermediating financial risk. The Company, in the normal course of business, may establish SPEs, sell assets to SPEs, underwrite, distribute and make a market in securities or other beneficial interests issued by SPEs, transact derivatives with SPEs, own securities or other beneficial interests, including residuals, in SPEs, and provide liquidity or other guarantees for SPEs.

The Company follows SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a Replacement of FASB Statement No. 125," to account for securitizations and other transfers of financial assets. In accordance with SFAS No. 140, the Company accounts for transfers of financial assets as sales provided that control has been relinquished. Control is deemed to be relinquished only when all of the following conditions have been met: (1) the assets have been isolated from the transferor, even in bankruptcy or other receivership; (2) the transferee is a Qualifying Special Purpose Entity ("QSPE") or has the right to pledge or exchange the assets received; and (3) the transferor has not maintained effective control over the transferred assets. Therefore, the Company derecognizes financial assets transferred in securitizations, provided that such transfer meets all of these criteria. See Note 4, "Transfers of Financial Assets and Liabilities," in the Notes to Condensed Consolidated Financial Statements for a more complete discussion of the Company's securitization activities.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Company regularly creates or transacts with entities that may be VIEs. These entities are an essential part of its securitization, asset management and structured finance businesses. In addition, the Company purchases and sells instruments that may be variable interests. The Company adopted FIN No. 46 (R)

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for its variable interests in fiscal 2004. The Company consolidates those VIEs in which the Company is the primary beneficiary. See Note 5, "Variable Interest Entities and Mortgage Loan Special Purpose Entities," in the Notes to Condensed Consolidated Financial Statements for a complete discussion of the consolidation of VIEs.

The majority of the SPEs that the Company sponsors or transacts with are QSPEs, which the Company does not consolidate in accordance with this guidance. QSPEs are entities that have little or no discretionary activities and may only passively hold assets and distribute cash generated by the assets they hold. The Company reflects the fair value of its interests in QSPEs on its balance sheet but does not recognize the assets or liabilities of QSPEs. QSPEs are employed extensively in the Company's mortgage and asset securitization business.

Certain other SPEs do not meet the requirements of a QSPE, because their activities are not sufficiently limited or they have entered into certain non-qualifying transactions. The Company follows the criteria in FIN No. 46 (R) in determining whether it should consolidate such entities. These SPEs are commonly employed in collateralized debt obligation transactions where portfolio managers require the ability to buy and sell assets or in synthetic credit transactions.

In addition to the above, in the ordinary course of business the Company issues various guarantees to counterparties in connection with certain derivatives, leasing, securitization and other transactions. See Note 11, "Guarantees," in the Notes to Condensed Consolidated Financial Statements for a complete discussion on guarantees.

DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments are contractual commitments between counterparties that derive their values from changes in an underlying interest rate, currency exchange rate, index (e.g., S&P 500), reference rate (e.g., LIBOR), or asset value referenced in the related contract. Some derivatives, such as futures contracts, certain options and index-referenced warrants, can be traded on an exchange. Other derivatives, such as interest rate and currency swaps, caps, floors, collars, swaptions, equity swaps and options, structured notes and forward contracts, are negotiated in the over-the-counter markets. Derivatives generate both on- and off-balance-sheet risks depending on the nature of the contract. The Company is engaged as a dealer in over-the-counter derivatives and, accordingly, enters into transactions involving derivative instruments as part of its customer-related and proprietary trading activities.

The Company's dealer activities require it to make markets and trade a variety of derivative instruments. In connection with these activities, the Company attempts to mitigate its exposure to market risk by entering into hedging transactions that may include over-the-counter derivative contracts or the purchase or sale of interest-bearing securities, equity securities, financial futures and forward contracts. The Company also utilizes derivative instruments to hedge proprietary market-making and trading activities. In this regard, the utilization of derivative instruments is designed to reduce or mitigate market risks associated with holding dealer inventories or in connection with arbitrage-related trading activities. The Company also utilizes interest rate and currency swaps, futures contracts and US Treasury positions to hedge certain debt issuances as part of its asset and liability management.

To measure derivative activity, notional or contract amounts are frequently used. Notional/contract amounts are used to calculate contractual cash flows to be exchanged and are generally not actually paid or received, with the exception of currency swaps, foreign exchange forwards and mortgage-backed securities forwards. The notional/contract amounts of financial instruments that give rise to off-balance-sheet market risk are indicative only to the extent of

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involvement in the particular class of financial instruments and are not necessarily an indication of overall market risk.

As of February 28, 2007 and November 30, 2006, the Company had notional/contract amounts of approximately \$8.63 trillion and \$8.74 trillion, respectively, of derivative financial instruments, of which \$1.34 trillion and \$1.25 trillion, respectively, were listed futures and option contracts. The aggregate notional/contract value of derivative contracts is a

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

reflection of the level of activity and does not represent the amounts that are recorded in the Condensed Consolidated Statements of Financial Condition. The Company's derivative financial instruments outstanding, which either are used to hedge trading positions, modify the interest rate characteristics of its long- and short-term debt, or are part of its derivative dealer activities, are marked to fair value.

The Company's derivatives had a notional weighted average maturity of approximately 4.4 years and 4.1 years at February 28, 2007 and November 30, 2006, respectively. The maturities of notional/contract amounts outstanding for derivative financial instruments as of February 28, 2007 were as follows:

| (in billions) | Less Than One Year | One to Three Years | Three to Five Years | Great Five |
|--|-----------------------|-----------------------|------------------------|----------------|
| Swap agreements, including options, swaptions, caps, collars and floors | \$ 1,561.2 | \$ 1,628.3 | \$ 1,674.5 | \$ 2,18 |
| Futures contracts | 489.1 | 389.5 | 37.9 | |
| Forward contracts | 170.9 | - | - | |
| Options held | 252.6 | 20.2 | 1.7 | |
| Options written | 194.8 | 14.4 | 1.8 | |
| Total | \$ 2,668.6 | \$ 2,052.4 | \$ 1,715.9 | \$ 2,18 |
| Percent of total | 30.9% | 23.8% | 19.9% | 2 |

CRITICAL ACCOUNTING POLICIES

The Condensed Consolidated Financial Statements of the Company are prepared in conformity with accounting principles generally accepted in the United States of America. These principles require management to make certain estimates and assumptions that could materially affect reported amounts in the financial statements (see Note 1, "Summary of Significant Accounting Policies," in the Notes to Condensed Consolidated Financial Statements). Critical accounting policies are those policies that are the most important to the financial statements and/or those that require significant management judgment related to matters that are uncertain.

Valuation of Financial Instruments

The Company has identified the valuation of financial instruments as a critical accounting policy due to the complex nature of certain of its products, the degree of judgment required to appropriately value these products and the pervasive impact of such valuation on the financial condition and earnings of the Company.

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

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

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Level 1: Inputs based on quoted market prices for identical assets or liabilities in active markets.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

(1) Financial Instruments Valued Based on Inputs That Are Quoted Market Prices for Identical Assets or Liabilities in Active Markets

The Company's valuation policy is to use quoted market prices from securities and derivatives exchanges where they are available and reliable. Financial instruments valued based on quoted market prices are primarily exchange-traded derivatives and listed equities. Financial instruments that are most typically valued using alternative approaches but for which the Company typically receives independent external valuation information include US Treasuries, other US Government and agency securities, as well as certain corporate debt securities.

(2) Financial Instruments Whose Inputs are Observable Market Based or Unobservable Inputs that are Corroborated By Market Data

The second broad category consists of financial instruments for which the Company does not receive quoted prices; therefore, models or other methodologies are utilized to value these financial instruments. Such models are primarily industry-standard models that consider various assumptions, including time

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value, yield curve, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. A degree of subjectivity is required to determine appropriate models or methodologies as well as appropriate underlying assumptions. This subjectivity makes these valuations inherently less reliable than quoted market prices. Financial instruments in this category include non-exchange-traded derivatives such as interest rate swaps, certain mortgage-backed securities and certain other cash instruments. For an indication of the Company's involvement in derivatives, including maturity terms, see the table setting forth notional/contract amounts outstanding in the preceding "Derivative Financial Instruments" section.

(3) Financial Instruments Whose Inputs Used to Determine the Fair Value Is Estimated Based on Internally Developed Models or Methodologies Utilizing Significant Assumptions or Other Data That Are Generally Less Readily Observable from Objective Sources

Certain complex financial instruments and other investments have significant data inputs that cannot be validated by reference to readily observable data. These instruments are typically illiquid, long dated or unique in nature and therefore engender considerable judgment by traders and their management who, as dealers in many of these instruments, have the appropriate knowledge to estimate data inputs that are less readily observable. For certain instruments, extrapolation or other methods are applied to observed market or other data to estimate assumptions that are not observable.

The Company participates in the underwriting, securitization or trading of non-performing mortgage-related assets, real estate assets and certain residuals. In addition, the Company has a portfolio of Chapter 13 and other credit card receivables from individuals. Certain of these high yield positions have limited price observability. In these instances, fair values are determined by statistical analysis of historical cash flows, default probabilities, recovery rates, time value of money and discount rates considered appropriate given the level of risk in the instrument and associated investor yield requirements.

The Company is also engaged in structuring and acting as principal in complex derivative transactions. Complex derivatives include certain long-dated equity derivatives, certain credit and municipal derivatives and other exotic derivative structures. These non-exchange-traded instruments may have immature or limited markets and, by their nature, involve complex valuation methodologies and models, which are often refined to correlate with the market risk of these instruments.

See Note 2 of Notes to Condensed Consolidated Financial Statements for a description of the financial assets and liabilities carried at fair value.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Controls Over Valuation of Financial Instruments

In recognition of the importance the Company places on the accuracy of its valuation of financial instruments as described in the three categories above, the Company engages in an ongoing internal review of its valuations. Members of

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the Controllers and Risk Management Departments perform analysis of internal valuations, typically on a monthly basis but often on an intra-month basis as well. These departments are independent of the trading areas responsible for valuing the positions. Results of the monthly validation process are reported to the Mark-to-Market Committee ("MTMC"), which is composed of senior management from the Risk Management and Controllers Departments. The MTMC is responsible for ensuring that the approaches used to independently validate the Company's valuations are robust, comprehensive and effective. Typical approaches include valuation comparisons with external sources, comparisons with observed trading, independent comparisons of key model valuation inputs, independent trade modeling and a variety of other techniques.

Merchant Banking

As part of its merchant banking activities, the Company participates from time to time in principal investments in leveraged transactions. As part of these activities, the Company originates, structures and invests in merger, acquisition, restructuring and leveraged capital transactions, including leveraged buyouts. The Company's principal investments in these transactions are generally made in the form of equity investments, equity-related investments or subordinated loans and have not historically required significant levels of capital investment.

Equity interests and securities acquired as a result of leveraged acquisition transactions are reflected in the condensed consolidated financial statements at their initial cost until significant transactions or developments indicate that a change in the carrying value of the securities is appropriate. This represents the Company's best estimate of exit price as defined by SFAS No. 157. Generally, the carrying values of these securities will be increased based on company performance and in those instances where market values are readily ascertainable by reference to substantial transactions occurring in the marketplace or quoted market prices. Reductions to the carrying value of these securities are made in the event that the Company's estimate of net realizable value has declined below the carrying value. See "Merchant Banking and Private Equity Investments" in Management's Discussion and Analysis for additional details.

Legal, Regulatory and Tax Contingencies

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

Reserves for litigation and regulatory proceedings are generally determined on a case-by-case basis and represent an estimate of probable losses after considering, among other factors, the progress of each case, prior experience, and the experience of others in similar cases, and the opinions and views of internal and external legal counsel. Because litigation is inherently unpredictable, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss related to such matters, the ultimate resolution, the timing of resolution or the amount of eventual settlement, fine, penalty or relief, if any.

The Company is subject to the income tax laws of the United States, its states and municipalities and those of the foreign jurisdictions in which the Company has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing

authorities. The Company must make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and must also make estimates about when in the future certain items affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Company regularly evaluates the likelihood of assessments in each of the taxing jurisdictions resulting from current and subsequent years' examinations and tax reserves are established as appropriate.

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The Company establishes reserves for potential losses that may arise out of litigation, regulatory proceedings and tax audits to the extent that such losses are probable and can be estimated, in accordance with SFAS No. 5, "Accounting for Contingencies." Once established, reserves are adjusted as additional information becomes available or when an event requiring a change to the reserves occurs. Significant judgment is required in making these estimates and the ultimate resolution may differ materially from the amounts reserved.

ACCOUNTING AND REPORTING DEVELOPMENTS

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

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

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

EFFECTS OF INFLATION

The Company's assets are primarily recorded at their current market value and, to a large extent, are liquid in nature. The rate of inflation affects the Company's expenses, such as employee compensation, office leasing costs, information technology and communications charges, which may not be readily recoverable in the price of services offered by the Company. In addition, to the extent that inflation causes interest rates to rise and has other adverse effects on the securities markets and on the value of securities held in inventory, it may adversely affect the Company's financial position and results of operations.

For a description of the Company's risk management policies, including a discussion of the Company's primary market risk exposures, which include interest rate risk, foreign exchange rate risk, equity price risk and commodity price risk, as well as a discussion of the Company's credit risk and a discussion of how those exposures are managed, refer to the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2006.

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Value-at-Risk

An estimation of potential losses that could arise from changes in market conditions is typically accomplished through the use of statistical models known as value-at-risk ("VaR") that seek to predict risk of loss based on historical and/or market-implied price and volatility patterns. VaR estimates the probability of the value of a financial instrument rising above or falling below a specified amount. The calculation uses the simulated changes in value of the market risk-sensitive financial instruments to estimate the amount of change in the current value that could occur at a specified probability level.

The Company has performed an entity-wide VaR analysis of the Company's financial assets and liabilities, including financial instruments owned and sold, repurchase and resale agreements and funding assets and liabilities. The Company regularly evaluates and enhances such VaR models in an effort to more accurately measure risk of loss. Certain equity-method investments and non-publicly traded investments are not reflected in the VaR results. The VaR related to certain non-trading financial instruments has been included in this analysis and is not reported separately because the amounts are not material. The calculation is based on a methodology that uses a one-day interval and a 95% confidence level. The Company uses a historical simulation approach for VaR, which is supplemented by statistical risk add-ons for risk factors that do not lend themselves readily to historical simulation. Historical simulation involves the generation of price movements in a portfolio using price sensitivities, and actual historical movements of the underlying risk factors to which the securities are sensitive. Risk factors incorporated via historical simulation include interest rate movements, yield curve shape, general market credit spreads, equity price movement, option volatility movement (for certain option types) and foreign exchange movement, among others. Risk factors incorporated via add-on factors include the risk of specific bond issuers, among others. The Company believes that its VaR methodologies are consistent with industry practices for these calculations.

VaR has inherent limitations, including reliance on historical data, which may not accurately predict future market risk, and the quantitative risk information generated is limited by the parameters established in creating the models. There can be no assurance that actual losses occurring on any one day arising from

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changes in market conditions will not exceed the VaR amounts shown below or that such losses will not occur more than once in 20 trading days. VaR is not likely to accurately predict exposures in markets that exhibit sudden fundamental changes or shifts in market conditions or established trading relationships. Many of the Company's hedging strategies are structured around likely established trading relationships and, consequently, those hedges may not be effective and VaR models may not accurately predict actual results. Furthermore, VaR calculated for a one-day horizon does not fully capture the market risk of positions that cannot be liquidated in a one-day period. However, the Company believes VaR models are an established methodology for the quantification of risk in the financial services industry despite these limitations. VaR is best used in conjunction with other financial disclosures in order to assess the Company's risk profile.

The aggregate VaR presented here is less than the sum of the individual components (i.e., interest rate risk, foreign exchange rate risk, equity risk, and commodity risk), due to the benefit of diversification among the risks. Diversification benefit equals the difference between aggregate VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the three primary market risk categories occur on different days and because of general diversification benefits introduced when risk is measured across a larger set of specific risk factors than exist in the respective categories; similar diversification benefits also are taken into account across risk factors within each category. The following table illustrates the VaR for each component of market risk as of February 28, 2007, November 30, 2006, August 31, 2006 and May 31, 2006.

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QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

| (in millions) | February 28, 2007 | November 30, 2006 | August 31, 2006 | May 31, 2006 |
|---|----------------------|----------------------|--------------------|-----------------|
| <hr style="border-top: 1px dashed black;"/> | | | | |
| MARKET RISK | | | | |
| Interest rate | \$ 27.6 | \$ 30.6 | \$ 37.7 | \$ 32.5 |
| Currency | 1.3 | 0.8 | 1.4 | 1.0 |
| Equity | 6.9 | 3.0 | 3.9 | 5.4 |
| Commodity/Energy | 1.0 | 0.0 | 0.0 | 0.0 |
| Diversification benefit | (8.9) | (5.7) | (9.1) | (8.1) |
| <hr style="border-top: 1px dashed black;"/> | | | | |
| Aggregate VaR | \$ 27.9 | \$ 28.7 | \$ 33.9 | \$ 30.8 |
| <hr style="border-top: 1px dashed black;"/> | | | | |

The table below illustrates the high, low and average VaR for each component of market risk and aggregate market risk during the quarters ended February 28, 2007 and November 30, 2006:

Quarter Ended February 28, 2007

Quarter Ended November 30, 2006

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| (in millions) | High | Low | Average | High | Low |
|--------------------|---------|---------|---------|---------|---------|
| MARKET RISK | | | | | |
| Interest rate | \$ 35.9 | \$ 22.8 | \$ 27.7 | \$ 41.3 | \$ 22.9 |
| Currency | 2.7 | 0.0 | 0.9 | 3.2 | 0.3 |
| Equity | 12.2 | 1.6 | 6.4 | 11.3 | 1.3 |
| Commodity/Energy | 1.8 | 0.1 | 1.0 | 0.6 | 0.0 |
| Aggregate VaR | 31.6 | 22.8 | 27.2 | 35.4 | 21.5 |

Aggregate average VaR decreased slightly to \$27.2 million for the 2007 quarter from \$27.5 for the quarter ended November 30, 2006. The decrease was primarily due to lower levels of exposure to interest rates, offset by higher levels of exposure to equity price risks.

The Company utilizes a wide variety of market risk management methods, including trading limits; marking all positions to market on a daily basis; daily profit and loss statements; position reports; daily risk highlight reports; aged inventory position reports; and independent verification of inventory pricing. Additionally, management of each trading department reports positions, profits and losses and notable trading strategies to the Risk Committee on a weekly basis. The Company believes that these procedures, which stress timely communication between traders, trading department management and senior management, are the most important elements of the risk management process.

Stress testing (also referred to as scenario analysis) measures the risk of loss over a variety of extreme market conditions that are defined in advance. Stress testing is a key methodology used in the management of market risk as well as counterparty credit risk (see "Credit Risk"). Stress tests are calculated at the firmwide level for particular trading books, customer accounts and individual positions. Stress tests are performed on a regular basis as well as on an ad hoc basis, as deemed appropriate. The ongoing evaluation process of trading risks as well as the consideration of new trading positions commonly incorporates an ad hoc discussion of "what-if" stressed market conditions and their impact on profitability. This analysis varies in its degree of formality based on the judgment of trading department management, risk management and senior managers. While the Company recognizes that no methodology can perfectly predict future market conditions, it believes that these tools are an important supplement to the Company's risk management process. The Company expects to continue to develop and refine its formal stress testing methodologies.

The following chart represents a summary of the daily principal transactions revenues and reflects a combination of trading revenues, net interest revenues for certain trading areas and other revenues for the quarters ended February 28, 2007 and 2006. The chart represents a historical summary of the results generated by the Company's trading activities as opposed to the probability approach used by the VaR model. The average daily trading profit was \$22.4 million and \$19.2 million for the quarters ended February 28, 2007 and 2006, respectively. There were 4 daily trading losses for the quarter ended February 28, 2007, one of which was slightly greater than the reported average VaR for the quarter, and 3 daily trading losses for the quarter ended February 28, 2006. None of the daily trading losses in the 2006 quarter exceeded the reported average VaR amounts. The frequency distribution of the Company's daily net trading revenues reflects the Company's historical ability to manage its exposure to market risk and the diversified nature of its trading activities.

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Market conditions were favorable for the Company's trading activity in both its quarters ending February 28, 2007 and 2006. Hedging strategies were generally effective as established trading relationships remained substantially intact and volatility tended to be lower than historical norms. No guarantee can be given regarding future net trading revenues or future earnings volatility. However, the Company believes that these results are indicative of its commitment to the management of market trading risk.

DISTRIBUTION OF DAILY NET TRADING REVENUES

Quarters Ended February 28, 2007 and February 28, 2006

[GRAPHIC CHART OMITTED]

The following is a graphic chart represented as a table.

| (10)+ | (10)-(5) | (5)-0 | 0-5 | 5-10 | 10-15 | 15-20 | 20-25 | 25-30 | 30-35 | 35-40 | 40+ | 200 |
|-------|----------|-------|-----|------|-------|-------|-------|-------|-------|-------|-----|-----|
| 4 | | | 5 | 2 | 5 | 12 | 8 | 10 | 6 | 2 | 6 | 200 |
| | | 3 | 6 | 6 | 9 | 11 | 9 | 6 | 3 | 2 | 5 | 200 |

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QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Credit Risk

The Company measures its actual credit exposure (the replacement cost of counterparty contracts) on a daily basis. Master netting agreements, collateral and credit insurance are used to mitigate counterparty credit risk. The credit exposures reflect these risk-reducing features to the extent they are legally enforceable. The Company's net replacement cost of derivative contracts in a gain position at February 28, 2007 and November 30, 2006 approximated \$4.71 billion and \$4.99 billion, respectively. Exchange-traded financial instruments, which typically are guaranteed by a highly rated clearing organization, have margin requirements that substantially mitigate the risk of credit loss.

The following table summarizes the counterparty credit quality of the Company's exposure with respect to over-the-counter derivatives (including foreign exchange and forward-settling mortgage transactions) as of February 28, 2007:

Over-the-Counter Derivative Credit Exposure (1)
(\$ in millions)

| Rating (2) | Exposure | Collateral (3) | Exposure, Net of Collateral (4) | Percentage of Exposure, Net of Collateral |
|------------|----------|-------------------|--|--|
| ----- | ----- | ----- | ----- | ----- |
| AAA | \$ 1,266 | \$ 54 | \$ 1,227 | 26% |
| AA | 5,164 | 3,630 | 1,808 | 38% |
| A | 2,816 | 1,822 | 1,117 | 24% |

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| | | | | |
|--------------|-------|-------|-----|----|
| BBB | 435 | 450 | 214 | 5% |
| BB and lower | 1,347 | 2,800 | 237 | 5% |
| Non-rated | 154 | 75 | 106 | 2% |

- (1) Excluded are covered transactions structured to ensure that the market values of collateral will at all times equal or exceed the related exposures. The net exposure for these transactions will, under all circumstances, be zero.
- (2) Internal counterparty credit ratings, as assigned by the Company's Credit Department, converted to rating agency equivalents.
- (3) For lower-rated counterparties, the Company generally receives collateral in excess of the current market value of derivative contracts.
- (4) In calculating exposure net of collateral, collateral amounts are limited to the amount of current exposure for each counterparty. Excess collateral is not applied to reduce exposure because such excess in one counterparty portfolio cannot be applied to deficient collateral in a different counterparty portfolio.

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Item 4. CONTROLS AND PROCEDURES

As required by Rule 13a-15(b) of the Exchange Act, the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of its disclosure controls and procedures as of the end of the period covered by this quarterly report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) were effective as of the end of the period covered by this quarterly report (i) to ensure that information required to be disclosed by the company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and (ii) to ensure that information required to be disclosed by the Company in the reports that the Company submits under the Exchange Act is accumulated and communicated to the Company's management, including the Company's principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. As required by Rule 13a-15(d) under the Exchange Act, the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the Company's internal control over financial reporting to determine whether any changes occurred during the quarter covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there have been no such changes during the quarter covered by this quarterly report.

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Part II - OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

In the normal course of business, the Company has been named a defendant in various legal actions, including arbitrations, class actions and other litigation. Certain of the legal actions include claims for substantial

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compensatory and/or punitive damages or claims for indeterminate amounts of damages. The Company is also involved in other reviews, investigations and proceedings by governmental and self-regulatory organizations regarding the Company's business. Certain of the foregoing could result in adverse judgments, settlements, fines, penalties or other relief.

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

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

Certain legal proceedings in which the Company is involved are discussed in Note 17 to the consolidated financial statements included in the Company's 2006 Financial Report; Part I, Item 3, of the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2006. The following discussion is limited to recent developments concerning our legal proceedings and should be read in conjunction with those earlier Reports.

Helen Gredd, Chapter 11 Trustee for Manhattan Investment Fund Ltd. v. Bear, Stearns Securities Corp.: As previously reported in the Company's Form 10-K for fiscal year ended November 30, 2006 ("Form 10-K"), in connection with the parties' cross motions for summary judgment, by Order and Decision dated January 9, 2007, the Bankruptcy Court denied BSSC's motion for summary judgment seeking dismissal of the Trustee's complaint in its entirety and granted the Trustee's motion for summary judgment on the fraudulent transfer claims against BSSC. BSSC has appealed the Bankruptcy Court's decision to the United States District for the Southern District of New York.

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Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The table below sets forth the information with respect to purchases made by the Company of the Company's common stock during the first quarter of fiscal 2007:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Approximat Value of Sha May Yet Be Under the Programs |
|--------------------|--|------------------------------------|---|---|
| 12/1/06 - 12/31/06 | 2,175,293 | \$ 164.20 | 2,175,293 | \$ 1,858 |
| 1/1/07 - 1/31/07 | 307,485 | 166.05 | 307,485 | 1,807 |

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| | | | | |
|------------------|-----------|--------|-----------|-------|
| 2/1/07 - 2/28/07 | 400,166 | 162.32 | 400,166 | 1,742 |
| | ----- | | ----- | |
| Total | 2,882,944 | 164.14 | 2,882,944 | |
| | ----- | | ----- | |

(1) On December 13, 2006, the Board of Directors of the Company approved an amendment to the Stock Repurchase Program ("Repurchase Program") to replenish the previous authorizations to allow the Company to purchase up to \$2.0 billion of common stock in fiscal 2007 and beyond. During the quarter ended February 28, 2007, the Company purchased under the current and prior authorizations a total of 2,634,388 shares at a cost of approximately of \$431.7 million. Approximately \$1.58 billion was available to be purchased under the current authorization as of February 28, 2007. The Company expects to utilize the repurchase authorization to offset the dilutive impact of annual share awards. The Company may, depending upon price and other factors, repurchase additional shares in excess of that required for annual share awards. During the quarter ended February 28, 2007, the Company also purchased a total of 248,556 shares of its common stock at a total cost of \$41.5 million pursuant to a \$200 million CAP Plan Earnings Purchase Authorization, which was approved by the Compensation Committee of the Board of Directors of the Company on December 12, 2006.

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Item 6. EXHIBITS

Exhibits

- (11) Computation of Per Share Earnings. (The calculation of per share earnings is in Note 8, "Earnings Per Share," of Notes to Condensed Consolidated Financial Statements (Earnings Per Share) and is omitted here in accordance with Section (b) (11) of Item 601 of Regulation S-K)
- (12) Computation of Ratio of Earnings to Fixed Charges and to Combined Fixed Charges and Preferred Stock Dividends
- (15) Letter re: Unaudited Interim Financial Information
- (31.1) Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- (31.2) Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- (32.1) Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- (32.2) Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURE

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.

The Bear Stearns Companies Inc.

(Registrant)

Date: April 10, 2007

By: /s/ Jeffrey M. Farber
Jeffrey M. Farber
Senior Vice President -
Finance,
Controller
(Principal Accounting
Officer)

THE BEAR STEARNS COMPANIES INC.
FORM 10-Q
EXHIBIT INDEX

| Exhibit No. ----- | Description ----- |
|----------------------|---|
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