

E TRADE FINANCIAL CORP  
Form 10-Q  
November 07, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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*(Mark One)*

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

For the quarterly period ended September 30, 2006

or

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

Commission file number 1-11921

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**E\*TRADE Financial Corporation**

(Exact name of Registrant as Specified in its Charter)

**Delaware**  
(State or other jurisdiction of

incorporation or organization)

135 East 57<sup>th</sup> Street, New York, New York 10022

(Address of Principal Executive Offices and Zip Code)

(646) 521-4300

(Registrant's Telephone Number, including Area Code)

**94-2844166**  
(I.R.S. Employer

Identification Number)

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

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

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

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

As of November 3, 2006, there were 426,951,622 shares of common stock outstanding.

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**E\*TRADE FINANCIAL CORPORATION**

**FORM 10-Q QUARTERLY REPORT**

**For the Quarter Ended September 30, 2006**

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**Signatures**

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*Unless otherwise indicated, references to the Company, We, Us, Our and E\*TRADE mean E\*TRADE Financial Corporation or its subsidiaries.*

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### **ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

#### **FORWARD-LOOKING STATEMENTS**

Certain statements made in this document are forward-looking statements that are made pursuant to the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements may sometimes be identified by words such as expect, may, looking forward, we plan, we believe, are planned, could be or currently anticipate. Although we believe these statements to be true, we give no assurance that any such plans, intentions or expectations will be achieved. Actual results, performance or achievements may differ materially from those contemplated, expressed or implied by any forward-looking statements, and we caution that we do not undertake to update forward-looking statements. Important factors that may cause actual results to differ materially from any forward-looking statements are set forth in our 2005 Form 10-K filed with the Securities and Exchange Commission (SEC) under the heading Risk Factors.

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

#### **GLOSSARY OF TERMS**

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

#### **OVERVIEW**

##### ***Strategy***

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

As we expand our global customer base, and increase the retail customer cash and credit products we hold on our balance sheet, we believe that our business will benefit. As our institutional business manages our balance sheet on an enterprise-wide basis, we become less dependent on revenue from market-driven customer trading activity, and our income, while still positioned to benefit from a strong equity market, becomes more recurring in nature. As a result, net operating interest income has become our leading category of revenue, and we anticipate this trend will continue.

##### ***Key Factors Affecting Financial Performance***

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

customer demand for our products and services;

competitors' pricing on similar products and services;



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interest rates and the shape of the interest rate yield curve; and

the performance of the equity and capital markets.

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

continuing our success in the acquisition, growth and retention of customers;

deepening customer acceptance of our investing, trading, banking and lending products, including E\*TRADE Complete;

disciplined expense control and improved operational efficiency;

maintaining strong overall asset quality; and

prudent risk and capital management.

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

|   | As of or for the<br>Three Months Ended<br>September 30, |          |  | Variance      | As of or for the<br>Nine Months Ended<br>September 30, |          |  | Variance      |
|---|---|----------|--|---------------|--|----------|--|---------------|
|   | 2006  | 2005     |  | 2006 vs. 2005 | 2006   | 2005     |  | 2006 vs. 2005 |
| <b>Customer Activity Metrics:</b>                               |   |          |  |               |  |          |  |               |
| Retail client assets (dollars in billions) <sup>(1)</sup>       | \$ 184.8  | \$ 106.4 |  | 74 %          | \$ 184.8   | \$ 106.4 |  | 74 %          |
| Customer cash and deposits (dollars in billions) <sup>(1)</sup> | \$ 31.6   | \$ 19.4  |  | 63 %          | \$ 31.6  | \$ 19.4  |  | 63 %          |
| Daily average revenue trades                                    | 135,130   | 93,876   |  | 44 %          | 160,589  | 87,599   |  | 83 %          |
| Average commission per trade                                    | \$ 11.95  | \$ 13.94 |  | (14)%         | \$ 12.10   | \$ 14.24 |  | (15)%         |
| Products per customer   | 2.1   | 2.0      |  | 5 %           | 2.1  | 2.0      |  | 5 %           |
| <b>Company Financial Metrics:</b>                               |   |          |  |               |  |          |  |               |
| Net revenue growth <sup>(2)</sup>                               | 39%   | 27%      |  | 12 %          | 46%  | 13%      |  | 33 %          |
| Enterprise net interest spread (basis points)                   | 286   | 252      |  | 13 %          | 288  | 246      |  | 17 %          |
| Enterprise interest-earning assets (average in billions)        | \$ 46.4   | \$ 32.7  |  | 42 %          | \$ 44.0  | \$ 31.3  |  | 40 %          |
| Operating margin <sup>(3)</sup>                                 | 38%   | 36%      |  | 2 %           | 41%  | 36%      |  | 5 %           |
| Compensation and benefits as a % of revenue                     | 19%   | 25%      |  | (6)%          | 20%  | 23%      |  | (3)%          |

(1) Customer cash and deposits, as well as retail client assets, have been re-presented to account for a methodology change in the metric to settlement date from trade date reporting as of December 31, 2005, which reduced both metrics by \$564 million. This is not a methodology change in accounting policy and does not impact the reporting of these items on our balance sheet.

(2) Revenue growth is the difference between the current and prior comparable period total net revenue divided by the prior comparable period total net revenue.

(3)

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

### *Customer Activity Metrics*

Retail client assets are an indicator of the value of our relationship with the customer. An increase in retail client assets generally indicates that the use of our products and services by existing and new customers is expanding. Changes in this metric are also driven by changes in the valuations of our customers' underlying securities.

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Customer cash and deposits are an indicator of a deepening engagement with our customers and a key driver of net operating interest income.

Daily average revenue trades ( DARTs ) are the predominant driver of commission revenue from our retail customers.

Average commission per trade is impacted by the mix between our retail domestic and international businesses. This is an indicator of changes in our customer mix, product mix or product pricing.

Products per customer is an indicator of our customer engagement and how well our suite of products and services appeal to our customer base. We believe increases to this measure represent better overall customer engagement with our products and services.

### *Company Financial Metrics*

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

Enterprise net interest spread is a broad indicator of our ability to generate net operating interest income.

Enterprise interest-earning assets are an indicator of our ability to generate net operating interest income, and growth in these assets, in conjunction with net operating interest spread, indicates our ability to grow net operating interest income.

Operating margin is an indicator of the profitability of our operations.

Compensation and benefits as a percentage of revenue is an indicator of our productivity. In recent periods, we have grown our revenue faster than our compensation expense. This ratio coupled with operating margin is an indicator of our increasing efficiency.

### ***Significant Events in the Third Quarter of 2006***

#### *Acquired Retirement Advisors of America ( RAA )*

We completed the purchase of RAA, a Dallas, Texas-based investment advisor managing over \$1 billion in assets. We believe this acquisition strengthens our regional advisor business, which delivers localized wealth management services and advice to retail clients with a minimum of \$250,000 in assets.

#### *Increased Ownership of IL&FS Investsmart Limited ( Investsmart<sup>(1)</sup> )*

We increased our ownership stake in Investsmart and now meet the criteria required to exercise significant influence, which now categorizes Investsmart as an equity method investment. In addition, we have made an open offer to purchase an additional 20% of Investsmart's outstanding shares, which, if successful, would increase our ownership percentage to as much as 48%.

#### *E\*TRADE Canada Pricing Change*

E\*TRADE Canada announced it will offer a flat fee on Canadian equity commissions to retail customers who hold \$50,000 or more in combined assets, or who conduct 30 or more trades per quarter. With this pricing change, E\*TRADE Canada is one of the first Canadian brokers to offer flat pricing to both Mass Affluent and Active Traders.

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### *E\*TRADE Germany Website Launch and Flat Fee Offer*

E\*TRADE Germany launched an updated website with new products and functionalities which supports both the English and German languages and introduces E\*TRADE Germany as the first broker in Germany to offer a flat fee on trading.

(1) Investsmart is an India-based financial services organization providing individuals and corporations with customized financial management solutions.

**Table of Contents***Upgraded Credit Rating*

Two credit agencies, Standard & Poors ( S&P ) and Dominion Bond Rating Service ( DBRS ), upgraded our senior unsecured debt rating during the third quarter of 2006. S&P upgraded our rating to BB- (stable) from B+ (positive) and DBRS upgraded our rating by two increments to BB (high) from BB (low). DBRS also upgraded the long-term deposit rating of E\*TRADE Bank to BBB (low) from BB. These increases are consistent with Moody's Investor Service upgrades on our senior unsecured debt rating from B1 to Ba2 and the long-term deposit rating of E\*TRADE Bank from Ba2 to Baa3 that occurred during the second quarter of 2006. We believe that our improved profitability and the diversity of our business model were key factors in receiving these upgrades and that these upgrades are an important acknowledgement of the progress we have made as a company.

*Enhanced Distribution Network*

We enhanced our distribution network by opening a new E\*TRADE Financial center during the period. With the addition of the King of Prussia, PA center, we increased the number of our nationwide financial centers to a total of 21.

**Summary Financial Results**

*Income Statement Highlights for the Three and Nine Months Ended September 30, 2006 (dollars in millions, except per share amounts)*

|                                     | <b>Three Months Ended<br/>September 30,</b> |             | <b>Variance</b>      | <b>Nine Months Ended<br/>September 30,</b> |             | <b>Variance</b>      |
|-------------------------------------|---|-------------|----------------------|--|-------------|----------------------|
|                                     | <b>2006</b>                                 | <b>2005</b> | <b>2006 vs. 2005</b> | <b>2006</b>                                | <b>2005</b> | <b>2006 vs. 2005</b> |
| Total net revenue                   | \$ 581.8                                    | \$ 419.8    | 39%                  | \$ 1,791.5                                 | \$ 1,224.9  | 46%                  |
| Net income                          | \$ 153.2                                    | \$ 107.5    | 43%                  | \$ 452.2                                   | \$ 301.1    | 50%                  |
| Diluted net earnings per share      | \$ 0.35                                     | \$ 0.28     | 25%                  | \$ 1.03                                    | \$ 0.79     | 30%                  |
| Operating margin <sup>(1)</sup>     | \$ 223.2                                    | \$ 152.0    | 47%                  | \$ 727.7                                   | \$ 445.5    | 63%                  |
| Operating margin (%) <sup>(2)</sup> | 38%   | 36%         | 2%                   | 41%  | 36%         | 5%                   |

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

(2) Percentage of net revenue that goes to operating margin. It is calculated by dividing operating margin by our total net revenue. During the third quarter of 2006, despite a decline in overall market activity, we continued to strengthen our operating and financial performance. Total net revenue and net income increased 39% and 43%, respectively, when compared to the corresponding period in the prior year. We believe these increases were driven both by our acquisitions of Harrisdirect LLC ( Harrisdirect ) and J.P. Morgan Invest, LLC ( BrownCo ) as well as by our ability to grow customer cash and deposits, margin receivables and DARTs. The growth in customer cash and deposits and margin receivables were the primary drivers of our increase in net operating interest income, and the growth in DARTs was the primary driver of our increase in commission revenue. We were able to achieve this growth while increasing our operating margin to 38% in the third quarter of 2006 from 36% when compared to the same period in the prior year. We believe this growth in operating margin reflects increasing efficiencies in our operations.

Net operating interest income after provision for loan losses increased 68% to \$342.6 million for the three months ended September 30, 2006, compared with the same period in 2005. Net operating interest income benefited from increases in customer cash and deposits coupled with growth in enterprise interest-earning assets. Customer cash and deposits, our lowest cost sources of funds, increased \$12.2 billion compared to the same period in 2005. The increase in customer cash and deposits resulted both from our acquisitions, which added \$8.0 billion of customer cash and deposits, and from organic growth, which added \$4.2 billion. We believe our

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organic growth is a result, in part, of the Intelligent Cash Optimizer within E\*TRADE Complete, which continues to drive growth in customer cash and deposit balances. Average enterprise interest-earning assets increased by \$13.7 billion in the third quarter of 2006 compared to the same period in 2005, partially driven by our acquisitions which added \$3.9 billion of margin receivables to our balance sheet.

Commission revenue increased 17% to \$133.6 million for the three months ended September 30, 2006, compared with the same period in 2005. The primary driver of this growth was an increase in DARTs to 135,130, an increase of 44% compared to the same quarter in 2005. Our U.S. DART volume increased 47% from the prior year, driven by both our acquisitions of BrownCo and Harrisdirect as well as organic customer growth and engagement. Our international DARTs grew by 28% compared to the same quarter in 2005, driven entirely by organic growth. Our international operations continue to be a strong growth contributor within our retail trading business, and we believe that over time it will become a significant component of our entire business. In addition, option-related DARTs further increased as a percentage of our total U.S. DARTs and now represent 13% of trading volume versus 10% a year ago.

*Balance Sheet Highlights (dollars in billions)*

|   | September 30,<br>2006 | December 31,<br>2005 | Variance<br>2006 vs. 2005 |
|---|-----------------------|----------------------|---------------------------|
| Total assets  | \$ 51.5               | \$ 44.6              | 16%                       |
| Total enterprise interest-earning assets  | \$ 46.4               | \$ 41.1              | 13%                       |
| Average loans, net and margin receivables as a percentage of enterprise interest-earning assets <sup>(1)(2)</sup>     | 64%                   | 61%                  | 3%                        |
| Average retail deposits and free credits as a percentage of enterprise interest-bearing liabilities <sup>(1)(2)</sup> | 61%                   | 54%                  | 7%                        |

<sup>(1)</sup> The table data on average enterprise interest-earning assets, loans, net and margin receivables, retail deposits and free credits has been prepared on the same basis as our disclosures with respect to the Bank under the SEC's Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*.

<sup>(2)</sup> Percentages calculated reflect data for the three months ended September 30, 2006 and December 31, 2005.

The increase in total assets was primarily attributable to increases of \$3.9 billion in loans, net and \$2.6 billion in available-for-sale mortgage-backed and investment securities. The increase, in loans, net was principally due to growth in our real estate loan portfolio. We continue to focus our efforts on growing our residential mortgage loan portfolios, including one- to four-family and home equity loans, and allowing our consumer loan portfolio to decline.

Retail deposits and free credits were \$27.9 billion, up 31% or \$6.7 billion during the first nine months of 2006. The increase related to the Harrisdirect conversion, as well as organic growth in checking, money market and certificates of deposit accounts. Retail deposits and free credits are two of our lowest cost sources of funding and are important contributors to our net operating interest income growth. In addition to acquired customer growth, we experienced organic growth which we believe is a result, in part, of the E\*TRADE Complete Intelligent Cash Optimizer, as well as an overall focus on price, functionality and service for our global retail customers.

**EARNINGS OVERVIEW**

Net income from continuing operations increased 38% to \$150.2 million and 40% to \$449.9 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. We experienced strong growth in customer cash and deposits as well as in DARTs. We also experienced growth in customer margin balances. In addition, we were able to achieve this growth while increasing our operating margin to 38% in the third quarter of 2006 from 36% when compared to the same period in the prior year. We believe this growth in operating margin is reflective of increasing efficiencies in our operations.

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During the nine month period ended September 30, 2006, we modified the format of our consolidated income statement to a format that we believe provides a clearer picture of our financial performance and is more consistent with the common presentation found in the financial services industry. We re-ordered the revenue section by placing net operating interest income, which we previously referred to as net interest income, first, and non-interest income second. In addition, we updated our expense presentation to eliminate the remaining bank/brokerage lines. In conjunction with this change, we created a new expense category, Clearing and servicing. This new category includes trade clearing-related expense, previously included in Commissions, clearance and floor brokerage, and most expenses previously included in Servicing and other banking expenses. We also consolidated Fair value adjustments of financial derivatives into the Other expense category. Information related to fair value adjustments of financial derivatives is detailed in Note 8 to the consolidated financial statements.

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

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

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

**Revenue**

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

|   | Three Months Ended<br>September 30, |            | Variance<br>2006 vs. 2005 |       | Nine Months Ended<br>September 30, |              | Variance<br>2006 vs. 2005 |       |
|---|-------------------------------------|------------|---------------------------|-------|------------------------------------|--------------|---------------------------|-------|
|   | 2006                                | 2005       | Amount                    | %     | 2006                               | 2005         | Amount                    | %     |
| <b>Revenue:</b>   |                                     |            |                           |       |                                    |              |                           |       |
| Operating interest income                                     | \$ 731,429                          | \$ 424,114 | \$ 307,315                | 72 %  | \$ 1,986,096                       | \$ 1,148,384 | \$ 837,712                | 73 %  |
| Operating interest expense                                    | (376,293)                           | (207,101)  | (169,192)                 | 82 %  | (961,569)                          | (535,532)    | (426,037)                 | 80 %  |
| Net operating interest income                                 | 355,136                             | 217,013    | 138,123                   | 64 %  | 1,024,527                          | 612,852      | 411,675                   | 67 %  |
| Provision for loan losses                                     | (12,547)                            | (12,909)   | 362                       | (3)%  | (33,014)                           | (37,946)     | 4,932                     | (13)% |
| Net operating interest income after provision for loan losses | 342,589                             | 204,104    | 138,485                   | 68 %  | 991,513                            | 574,906      | 416,607                   | 72 %  |
| Commission  | 133,606                             | 114,278    | 19,328                    | 17 %  | 476,771                            | 323,111      | 153,660                   | 48 %  |
| Service charges and fees                                      | 33,910                              | 32,893     | 1,017                     | 3 %   | 99,540                             | 100,639      | (1,099)                   | (1)%  |
| Principal transactions  | 22,697                              | 23,793     | (1,096)                   | (5)%  | 84,979                             | 75,547       | 9,432                     | 12 %  |
| Gain on sales of loans and securities, net                    | 16,003                              | 21,850     | (5,847)                   | (27)% | 38,738                             | 84,121       | (45,383)                  | (54)% |
| Other revenue   | 32,961                              | 22,918     | 10,043                    | 44 %  | 99,932                             | 66,596       | 33,336                    | 50 %  |
| Total non-interest income                                     | 239,177                             | 215,732    | 23,445                    | 11 %  | 799,960                            | 650,014      | 149,946                   | 23 %  |
| Total net revenue   | \$ 581,766                          | \$ 419,836 | \$ 161,930                | 39 %  | \$ 1,791,473                       | \$ 1,224,920 | \$ 566,553                | 46 %  |

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Net operating interest income after provision for loan losses continues to be our largest source of revenue and now represents 59% and 55% of total net revenue for the three and nine months ended September 30, 2006, respectively. This reflects our focus on retaining retail customer cash and deposits and retail credit balances. Net operating interest income is earned primarily through holding credit balances, which includes margin, real estate and consumer loans, and by holding customer cash and deposits, which are a low cost source of funding. The table below presents each revenue component as a percentage of total net revenue.

|   | Three Months Ended<br>September 30, |      | Variance      | Nine Months Ended<br>September 30, |      | Variance      |
|---|-------------------------------------|------|---------------|------------------------------------|------|---------------|
|   | 2006                                | 2005 | 2006 vs. 2005 | 2006                               | 2005 | 2006 vs. 2005 |
| <b>Revenue:</b>   |                                     |      |               |                                    |      |               |
| Net operating interest income after provision for loan losses | 59%                                 | 49%  | 10 %          | 55%                                | 47%  | 8 %           |
| Commission  | 23                                  | 27   | (4)           | 27                                 | 26   | 1             |
| Service charges and fees                                      | 6                                   | 8    | (2)           | 6                                  | 8    | (2)           |
| Principal transactions  | 4                                   | 6    | (2)           | 5                                  | 6    | (1)           |
| Gain on sales of loans and securities, net                    | 3                                   | 5    | (2)           | 2                                  | 7    | (5)           |
| Other revenue   | 5                                   | 5    |               | 5                                  | 6    | (1)           |
| Total net revenue   | 100%                                | 100% | %             | 100%                               | 100% | %             |

*Net Operating Interest Income After Provision for Loan Losses*

Net operating interest income after provision for loan losses increased 68% to \$342.6 million and 72% to \$991.5 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increase in net operating interest income primarily is due to growth in enterprise interest-earning assets coupled with an increase in enterprise net interest spread. The growth in enterprise interest-earning assets was driven by increases in both loans, net and margin receivables. The increase in enterprise net interest spread was driven by changes in our mix of lending and funding sources. Average loans, net and margin receivables as a percentage of average enterprise interest-earning assets increased 5% to 64% and 10% to 63% for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. Average retail deposits and free credits as a percentage of average enterprise interest-bearing liabilities increased 8% to 61% and 10% to 63% for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005.

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The following table presents enterprise average balance sheet data and enterprise income and expense data for our operations, as well as the related net interest spread, and has been prepared on the same basis as our disclosures with respect to E\*TRADE Bank under the SEC's Industry Guide 3, *Statistical Disclosure by Bank Holding Companies* (dollars in thousands):

|   | Three Months Ended September 30, |                                   |                    |                      |                                   |                    |
|---|----------------------------------|-----------------------------------|--------------------|----------------------|-----------------------------------|--------------------|
|   | Average Balance                  | 2006 Operating Interest Inc./Exp. | Average Yield/Cost | Average Balance      | 2005 Operating Interest Inc./Exp. | Average Yield/Cost |
| <b>Enterprise interest-earning assets:</b>                |                                  |                                   |                    |                      |                                   |                    |
| Loans, net  | \$ 22,955,022                    | \$ 364,744                        | 6.36%              | \$ 17,024,600        | \$ 232,004                        | 5.45%              |
| Margin receivables  | 6,645,017                        | 123,855                           | 7.39%              | 2,267,918            | 37,844                            | 6.62%              |
| Mortgage-backed and related available-for-sale securities | 12,068,052                       | 159,199                           | 5.28%              | 9,059,130            | 97,537                            | 4.31%              |
| Available-for-sale investment securities                  | 3,220,054                        | 51,885                            | 6.44%              | 1,937,276            | 25,888                            | 5.35%              |
| Trading securities  | 114,806                          | 2,600                             | 9.06%              | 186,377              | 2,792                             | 5.99%              |
| Cash and cash equivalents <sup>(1)</sup>                  | 974,738                          | 11,272                            | 4.59%              | 1,793,028            | 14,950                            | 3.31%              |
| Stock borrow and other                                    | 422,010                          | 8,690                             | 8.17%              | 422,076              | 5,654                             | 5.31%              |
| <b>Total enterprise interest-earning assets</b>           | <b>\$ 46,399,699</b>             | <b>722,245</b>                    | <b>6.22%</b>       | <b>\$ 32,690,405</b> | <b>416,669</b>                    | <b>5.10%</b>       |
| <b>Enterprise interest-bearing liabilities:</b>           |                                  |                                   |                    |                      |                                   |                    |
| Retail deposits   | \$ 20,992,962                    | 141,035                           | 2.67%              | \$ 13,095,471        | 57,710                            | 1.75%              |
| Brokered certificates of deposit                          | 618,681                          | 7,453                             | 4.78%              | 540,575              | 4,815                             | 3.53%              |
| Free credits  | 5,794,586                        | 18,326                            | 1.25%              | 3,406,685            | 4,733                             | 0.55%              |
| Repurchase agreements and other borrowings                | 11,586,260                       | 150,837                           | 5.09%              | 9,510,214            | 91,520                            | 3.77%              |
| Federal Home Loan Bank ( FHLB ) advances                  | 3,583,663                        | 43,950                            | 4.80%              | 4,093,294            | 40,914                            | 3.91%              |
| Stock loan and other                                      | 1,283,026                        | 11,617                            | 3.59%              | 426,729              | 2,025                             | 1.88%              |
| <b>Total enterprise interest-bearing liabilities</b>      | <b>\$ 43,859,178</b>             | <b>373,218</b>                    | <b>3.36%</b>       | <b>\$ 31,072,968</b> | <b>201,717</b>                    | <b>2.58%</b>       |
| <b>Enterprise net interest income/spread</b>              |                                  | <b>\$ 349,027</b>                 | <b>2.86%</b>       |                      | <b>\$ 214,952</b>                 | <b>2.52%</b>       |

Reconciliation from enterprise net interest income to net operating interest income (dollars in thousands):

|  | Three Months Ended September 30, |                   |
|--|----------------------------------|-------------------|
|  | 2006                             | 2005              |
| Enterprise net interest income <sup>(2)</sup>      | \$ 349,027                       | \$ 214,952        |
| Taxable equivalent interest adjustment             | (5,246)                          | (2,599)           |
| Stock conduit, net <sup>(3)</sup>                  | 14                               | 339               |
| Customer cash held by third parties <sup>(4)</sup> | 11,341                           | 4,321             |
| <b>Net operating interest income</b>               | <b>\$ 355,136</b>                | <b>\$ 217,013</b> |

<sup>(1)</sup> Includes segregated cash balances.

<sup>(2)</sup> Enterprise net interest income is taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties. Management believes this non-GAAP measure is useful to analysts and investors as it is a measure of the net operating interest income generated by our operations.

<sup>(3)</sup> Net operating interest income earned on average stock conduit assets of \$0.03 billion and \$0.7 billion for the quarters ended September 30, 2006 and 2005, respectively.

<sup>(4)</sup>

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Includes interest earned on average customer assets of \$3.6 billion and \$1.7 billion for the quarters ended September 30, 2006 and 2005, respectively, held by parties outside E\*TRADE Financial, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions.

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|   | Nine Months Ended September 30, |  |                       |                      |  |                       |
|---|---------------------------------|--|-----------------------|----------------------|--|-----------------------|
|   | Average<br>Balance              | 2006<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/Cost | Average<br>Balance   | 2005<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/Cost |
| <b>Enterprise interest-earning assets:</b>                |                                 |  |                       |                      |  |                       |
| Loans, net  | \$ 20,994,403                   | \$ 949,513                                 | 6.03%                 | \$ 14,517,416        | \$ 569,191                                 | 5.23%                 |
| Margin receivables  | 6,702,436                       | 352,149                                    | 7.02%                 | 2,216,424            | 101,110                                    | 6.10%                 |
| Mortgage-backed and related available-for-sale securities | 11,451,932                      | 432,077                                    | 5.03%                 | 9,139,878            | 285,366                                    | 4.16%                 |
| Available-for-sale investment securities                  | 2,931,914                       | 136,561                                    | 6.21%                 | 2,957,416            | 112,115                                    | 5.05%                 |
| Trading securities  | 131,885                         | 8,194                                      | 8.28%                 | 308,240              | 9,631                                      | 4.17%                 |
| Cash and cash equivalents <sup>(1)</sup>                  | 1,259,239                       | 40,592                                     | 4.31%                 | 1,717,698            | 38,837                                     | 3.02%                 |
| Stock borrow and other                                    | 481,809                         | 25,215                                     | 7.00%                 | 438,029              | 14,957                                     | 4.57%                 |
| <b>Total enterprise interest-earning assets</b>           | <b>\$ 43,953,618</b>            | <b>1,944,301</b>                           | <b>5.90%</b>          | <b>\$ 31,295,101</b> | <b>1,131,207</b>                           | <b>4.82%</b>          |
| <b>Enterprise interest-bearing liabilities:</b>           |                                 |  |                       |                      |  |                       |
| Retail deposits   | \$ 19,664,315                   | 346,602                                    | 2.36%                 | \$ 12,407,871        | 147,570                                    | 1.59%                 |
| Brokered certificates of deposit                          | 539,508                         | 18,262                                     | 4.53%                 | 429,568              | 10,818                                     | 3.37%                 |
| Free credits  | 6,319,950                       | 51,656                                     | 1.09%                 | 3,320,539            | 11,861                                     | 0.48%                 |
| Repurchase agreements and other borrowings                | 10,680,195                      | 391,460                                    | 4.83%                 | 9,995,414            | 261,492                                    | 3.45%                 |
| FHLB advances   | 3,161,930                       | 108,696                                    | 4.53%                 | 3,026,553            | 86,358                                     | 3.76%                 |
| Stock loan and other                                      | 1,031,071                       | 24,301                                     | 3.15%                 | 453,485              | 4,630                                      | 1.37%                 |
| <b>Total enterprise interest-bearing liabilities</b>      | <b>\$ 41,396,969</b>            | <b>940,977</b>                             | <b>3.02%</b>          | <b>\$ 29,633,430</b> | <b>522,729</b>                             | <b>2.36%</b>          |
| <b>Enterprise net interest income/spread</b>              |                                 | <b>\$ 1,003,324</b>                        | <b>2.88%</b>          |                      | <b>\$ 608,478</b>                          | <b>2.46%</b>          |

Reconciliation from enterprise net interest income to net operating interest income (dollars in thousands):

|  | Nine Months Ended<br>September 30, |                   |
|--|------------------------------------|-------------------|
|  | 2006                               | 2005              |
| Enterprise net interest income <sup>(2)</sup>      | \$ 1,003,324                       | \$ 608,478        |
| Taxable equivalent interest adjustment             | (12,944)                           | (7,869)           |
| Stock conduit, net <sup>(3)</sup>                  | 408                                | 873               |
| Customer cash held by third parties <sup>(4)</sup> | 33,739                             | 11,370            |
| <b>Net operating interest income</b>               | <b>\$ 1,024,527</b>                | <b>\$ 612,852</b> |

<sup>(1)</sup> Includes segregated cash balances.

<sup>(2)</sup> Enterprise net interest income is taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties. Management believes this non-GAAP measure is useful to analysts and investors as it is a measure of the net operating interest income generated by our operations.

<sup>(3)</sup> Net operating interest income earned on average stock conduit assets of \$0.4 billion and \$0.6 billion for the nine months ended September 30, 2006 and 2005, respectively.

<sup>(4)</sup> Includes interest earned on average customer assets of \$3.5 billion and \$2.1 billion for the nine months ended September 30, 2006 and 2005, respectively, held by parties outside E\*TRADE Financial, including third party money market funds and sweep deposit accounts at unaffiliated financial institutions.

Despite the flat to inverted yield curve during the period, enterprise net interest spread increased by 34 basis points to 2.86% and by 42 basis points to 2.88% for the three and nine months ended September 30, 2006, respectively, compared to same periods in 2005. This increase was primarily the result of our ability to grow low-cost deposits and free credits during these periods, which in turn funded our growth in loans, net and margin receivables.

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Average enterprise interest-earning assets increased 42% to \$46.4 billion and 40% to \$44.0 billion for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. Average

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loans, net and margin receivables grew 53% to \$29.6 billion and 66% to \$27.7 billion for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. Average loans, net grew as a result of our focus on mortgage loan products, specifically our home equity lines of credit ( HELOC ) portfolio. The margin loan portfolio grew, in part, as a result of our acquisitions of *Harrisdirect* and *BrownCo*, as well as organic growth.

Average enterprise interest-bearing liabilities increased 41% to \$43.9 billion and 40% to \$41.4 billion for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increase in average enterprise interest-bearing liabilities was primarily in low-cost customer cash and deposits. Average retail deposits and free credits increased 62% to \$26.8 billion and 65% to \$26.0 billion for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. Increases in average retail deposits and free credits were driven by our acquisitions of *Harrisdirect* and *BrownCo*, as well as by organic growth.

Our interest rate risk is impacted by external factors such as the level and shape of the interest rate yield curve and the impact of the competitive environment on our pricing. We utilize interest rate derivatives to manage this risk. In recent years, we have managed our interest rate risk to achieve a minimum to moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations.

### *Provision for Loan Losses*

Provision for loan losses decreased 3% to \$12.5 million and 13% to \$33.0 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The decrease in the provision for loan losses is primarily related to a lower provision for our consumer loan portfolio in connection with the decline in the overall consumer loan portfolio. However, we anticipate that the provision for our mortgage portfolio will increase as we grow our mortgage portfolio and we expect the provision for the mortgage portfolio to increase at a higher rate than the decline in the provision for our consumer portfolio.

### *Commission*

Commission revenue increased 17% to \$133.6 million and 48% to \$476.8 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The primary factors that affect our commission revenue are DARTs and average commission per trade, which is impacted by both trade types and the mix between our domestic and international businesses. Each business has a different pricing structure, unique to its customer base and local market practices, and as a result, a change in the executed trades between these businesses impacts average commission per trade. Each business also has different trade types (e.g. equities, options, fixed income and mutual funds) that can have different commission rates. As a result, changes in the mix of trade types within either of these businesses may impact average commission per trade.

Average commission per trade decreased 14% to \$11.95 and 15% to \$12.10 for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The decrease primarily was a function of the mix of customers. Main Street Investors, who generally have a higher commission per trade, traded less during the period which resulted in a heavier weighting of Active Traders, who generally have a lower commission per trade. In addition, we extended a conversion-related free trade offer to *Harrisdirect* customers during the first three months of the year.

Retail commission revenue increased \$17.1 million and \$128.6 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005 due to higher volumes (DARTs), offset by lower average commission per trade. The increase in DART volumes was the result of the *Harrisdirect* and *BrownCo* acquisitions as well as strong organic and overall market growth in domestic equity, international equity and option trades.

Due to the factors described above, our 44% and 83% growth in DARTs for the three and nine months ended September 30, 2006, respectively, equated to a 20% and 55% increase in retail commission revenue during

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the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005; however, our business model derives revenue not only from trades but also from other aspects of the relationship we have with our customers, especially those who maintain deposits, free credit and lending balances with us. Our average customer uses at least 2 products or services from our suite of retail products, which is the main driver in our diversification of revenue. For the three and nine months ended September 30, 2006, retail commission revenue represents 17% and 20% of total net revenue, respectively.

Institutional commission revenue increased \$2.2 million and \$25.1 million for the three and nine months ended September 30, 2006 compared to the same periods in 2005. These increases were due to a more favorable trading environment and to the continued leveraging of our integrated institutional model with higher retail order flow. We provide institutional customers with global execution and settlement services, as well as worldwide access to research provided by third parties, in exchange for commissions based on negotiated rates, which differ by customer.

*Service Charges and Fees*

Service charges and fees increased 3% to \$33.9 million for the three months ended September 30, 2006, and decreased 1% to \$99.5 million for the nine months ended September 30, 2006, compared to the same periods in 2005. The increase in service charges and fees for the third quarter primarily was due to an increase in the advisory service fee income. For the nine months ended September 30, 2006, however, this increase was offset by a decrease in account maintenance fees as our retail customers became more engaged and a greater number of customers exceeded the minimum activity levels required to avoid account maintenance fees. We expect our account maintenance fee income to continue to decline over time; however, we expect our advisory service fee income, which is not currently a significant portion of service charges and fees, to increase over time as we focus on growing this product.

*Principal Transactions*

Principal transactions decreased 5% to \$22.7 million for the three months ended September 30, 2006, and increased 12% to \$85.0 million for the nine months ended September 30, 2006, compared to the same periods in 2005. The decrease in principal transactions for the third quarter primarily resulted from a decline in market trading volumes during the period. For the nine months ended September 30, 2006, the increase in principal transactions resulted from higher trading volumes and market volatility which were offset slightly by a decrease in the average revenue earned per trade. Our principal transactions revenue is influenced by overall trading volumes, the number of stocks for which we act as a market maker, the trading volumes of those specific stocks and the trading performance of our proprietary trading activities.

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

Gain on sales of loans and securities, net decreased 27% to \$16.0 million and 54% to \$38.7 million for the three and nine months ended September 30, 2006 compared to the same periods in 2005, as shown in the following table (dollars in thousands):

|  | Three Months Ended<br>September 30, |           | Variance<br>2006 vs. 2005 |        | Nine Months Ended<br>September 30, |           | Variance<br>2006 vs. 2005 |       |
|--|-------------------------------------|-----------|---------------------------|--------|------------------------------------|-----------|---------------------------|-------|
|  | 2006                                | 2005      | Amount                    | %      | 2006                               | 2005      | Amount                    | %     |
| Gain on sales of originated loans:               |                                     |           |                           |        |                                    |           |                           |       |
| Mortgage loans                                   | \$ 3,213                            | \$ 12,371 | \$ (9,158)                | (74)%  | \$ 9,032                           | \$ 32,513 | \$ (23,481)               | (72)% |
| Consumer loans <sup>(1)</sup>                    |                                     | 2,440     | (2,440)                   | (100)% | 180                                | 14,634    | (14,454)                  | (99)% |
| Gain on sales of originated loans                | 3,213                               | 14,811    | (11,598)                  | (78)%  | 9,212                              | 47,147    | (37,935)                  | (80)% |
| Loss on sales of loans held-for-sale, net        | (235)                               | (543)     | 308                       | (57)%  | (1,333)                            | (1,442)   | 109                       | (8)%  |
| Gain on sales of loans, net                      | 2,978                               | 14,268    | (11,290)                  | (79)%  | 7,879                              | 45,705    | (37,826)                  | (83)% |
| Gain on sales of securities, net                 | 13,025                              | 7,582     | 5,443                     | 72 %   | 30,859                             | 38,416    | (7,557)                   | (20)% |
| Total gain on sales of loans and securities, net | \$ 16,003                           | \$ 21,850 | \$ (5,847)                | (27)%  | \$ 38,738                          | \$ 84,121 | \$ (45,383)               | (54)% |

<sup>(1)</sup> Consumer loans originated by our retail segment are sold to our institutional segment at an arm's length transfer price. The gains (losses) associated with our retail segment were reclassified to discontinued operations and the amounts related to our institutional segment remained in continuing operations.

The decline in the total gain on sales of loans and securities, net during the three and nine months ended September 30, 2006 primarily was due to our lower sales of mortgage and consumer loans compared to the same periods in 2005. We retained a greater number of originated mortgage loans on the balance sheet in an effort to retain the customer relationship and drive growth in net operating interest income. Gain on sales of consumer loans was lower due to the sale of the consumer finance business in 2005. Lower gain on sales of securities, net resulted from lower sales volumes in the nine months ended September 30, 2006 compared to the same period last year. Higher gain on sales of securities, net resulted from higher sales volumes in the three months ended September 30, 2006 compared to the same period last year.

### Other Revenue

Other revenue increased 44% to \$33.0 million and 50% to \$99.9 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increases were the result of higher payment for order flow from improved option and equity trading volumes, offset by decreases in proprietary fund revenue relating to the closure of certain of our proprietary funds. In addition, other revenue includes foreign exchange margin revenue, stock plan administration products revenue and other revenue ancillary to our retail customer transactions.

**Table of Contents****Expense Excluding Interest**

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

|  | Three Months Ended<br>September 30, |                   | Variance<br>2006 vs. 2005 |            | Nine Months Ended<br>September 30, |                   | Variance<br>2006 vs. 2005 |            |
|--|-------------------------------------|-------------------|---------------------------|------------|------------------------------------|-------------------|---------------------------|------------|
|  | 2006                                | 2005              | Amount                    | %          | 2006                               | 2005              | Amount                    | %          |
| Compensation and benefits                        | \$ 110,705                          | \$ 103,084        | \$ 7,621                  | 7%         | \$ 352,334                         | \$ 280,472        | \$ 71,862                 | 26%        |
| Clearing and servicing                           | 62,500                              | 46,930            | 15,570                    | 33%        | 189,926                            | 132,720           | 57,206                    | 43%        |
| Advertising and marketing development            | 23,914                              | 21,188            | 2,726                     | 13%        | 89,115                             | 74,252            | 14,863                    | 20%        |
| Communications                                   | 25,576                              | 18,210            | 7,366                     | 40%        | 84,818                             | 54,650            | 30,168                    | 55%        |
| Professional services                            | 20,741                              | 16,703            | 4,038                     | 24%        | 71,715                             | 53,168            | 18,547                    | 35%        |
| Depreciation and amortization                    | 18,565                              | 18,443            | 122                       | 1%         | 56,181                             | 53,310            | 2,871                     | 5%         |
| Occupancy and equipment                          | 22,150                              | 16,249            | 5,901                     | 36%        | 63,082                             | 50,673            | 12,409                    | 24%        |
| Amortization of other intangibles                | 12,087                              | 4,382             | 7,705                     | 176%       | 35,391                             | 13,751            | 21,640                    | 157%       |
| Facility restructuring and other exit activities | 16,684                              | (469)             | 17,153                    | *          | 19,315                             | 495               | 18,820                    | *          |
| Other  | 45,675                              | 23,129            | 22,546                    | 97%        | 101,888                            | 65,917            | 35,971                    | 55%        |
| <b>Total expense excluding interest</b>          | <b>\$ 358,597</b>                   | <b>\$ 267,849</b> | <b>\$ 90,748</b>          | <b>34%</b> | <b>\$ 1,063,765</b>                | <b>\$ 779,408</b> | <b>\$ 284,357</b>         | <b>36%</b> |

\* Percentage not meaningful

Expense excluding interest increased 34% to \$358.6 million and 36% to \$1,063.8 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increase in expense excluding interest primarily was driven by facility restructuring activities, higher trading volumes, a larger balance sheet and an increase in fraud related losses.

**Compensation and Benefits**

Compensation and benefits increased 7% to \$110.7 million and 26% to \$352.3 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. This increase resulted primarily from three factors: (1) higher numbers of employees in our service organization; (2) stock option expense<sup>(1)</sup>; and (3) an increase in variable and incentive compensation. These increases in compensation are in line with the growth and performance of our business. We believe compensation and benefits as a percentage of revenue is a measure of our efficiency and the most relevant metric to assess this increase. This ratio declined from 25% and 23% for the three and nine months ended September 30, 2005 to 19% and 20% for the three and nine months ended September 30, 2006.

**Clearing and Servicing**

Clearing and servicing expense increased 33% to \$62.5 million and 43% to \$189.9 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. This increase is a result of higher trading volumes and higher loan balances during the period.

<sup>(1)</sup> In July 2005 we adopted Statement of Financial Accounting Standard ( SFAS ) No. 123 (R), *Share-Based Payment*, which requires the expensing of stock options. Stock option expense was \$6.2 million and \$20.0 million for the three and nine months ended September 30, 2006. Stock option expense was \$7.1 million for the three and nine months ended September 30, 2005.

**Table of Contents***Communications*

Communications expense increased 40% to \$25.6 million and 55% to \$84.8 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increase is due to expenses associated with communications to our newly acquired customers from *Harrisdirect* and *BrownCo*. In addition, variable expenses such as quote services and trade confirmations increased with our increase in trading volume.

*Professional Services*

Professional services increased 24% to \$20.7 million and 35% to \$71.7 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increase primarily is due to third party support services, including technology and transitional service agreements, associated with our acquisitions of *Harrisdirect* and *BrownCo*.

*Amortization of Other Intangibles*

Amortization of other intangibles increased 176% to \$12.1 million and 157% to \$35.4 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increase in amortization expense primarily is due to the increase in customer-related intangible assets, which were created as a result of the *Harrisdirect* and *BrownCo* acquisitions.

*Facility Restructuring and Other Exit Activities*

Facility and restructuring costs were \$16.7 million and \$19.3 million for the three and nine months ended September 30, 2006, respectively. During the period, we relocated certain functions out of the state of California. This expense represents severance charges for those employees to whom we communicated our plans and who were terminated as part of this relocation in the third quarter, in addition to certain facility costs as a result of ceasing operations at these locations.

*Other*

Other expenses increased 97% to \$45.7 million and 55% to \$101.9 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. These increases were primarily due to fraud related losses during the third quarter of 2006 of \$18.1 million, of which \$10.0 million was identity theft related. The identity theft situations arose from recent computer viruses that attacked the personal computers of our customers, not from a breach of the security of our systems. We reimbursed customers for their losses through our Complete Protection Guarantee. These fraud schemes have impacted our industry as a whole. While we believe our systems remain safe and secure, we have implemented technological and operational changes to deter unauthorized activity in our customer accounts.

*Other Income (Expense)*

Other income (expense) decreased to an expense of \$6.5 million and to an expense of \$47.6 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005, as shown in the following table (dollars in thousands):

|   | Three Months Ended<br>September 30, |           | Variance<br>2006 vs. 2005 |       | Nine Months Ended<br>September 30, |           | Variance<br>2006 vs. 2005 |       |
|---|-------------------------------------|-----------|---------------------------|-------|------------------------------------|-----------|---------------------------|-------|
|   | 2006                                | 2005      | Amount                    | %     | 2006                               | 2005      | Amount                    | %     |
| Other income (expense):                           |                                     |           |                           |       |                                    |           |                           |       |
| Corporate interest income                         | \$ 1,942                            | \$ 3,409  | \$ (1,467)                | (43)% | \$ 6,091                           | \$ 7,796  | \$ (1,705)                | (22)% |
| Corporate interest expense                        | (37,964)                            | (13,783)  | (24,181)                  | 175 % | (114,586)                          | (36,975)  | (77,611)                  | 210 % |
| Gain on sales and impairment of investments       | 26,991                              | 22,028    | 4,963                     | 23 %  | 59,897                             | 68,172    | (8,275)                   | (12)% |
| Loss on early extinguishment of debt              |                                     |           |                           | *     | (703)                              |           | (703)                     | *     |
| Equity in income of investments and venture funds | 2,519                               | 3,103     | (584)                     | (19)% | 1,701                              | 7,142     | (5,441)                   | (76)% |
| Total other income (expense)                      | \$ (6,512)                          | \$ 14,757 | \$ (21,269)               | *     | \$ (47,600)                        | \$ 46,135 | \$ (93,735)               | *     |

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\* Percentage not meaningful

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The other expense for the three and nine months ended September 30, 2006 primarily consisted of corporate interest expense resulting from the funding of the Harrisdirect and BrownCo acquisitions beginning in late 2005. Offsetting corporate interest expense was \$27.0 million and \$59.9 million for the three and nine months ended September 30, 2006, respectively, in gain on sales and impairment of investments. During the nine months ended September 30, 2006, we sold shares of our investments in Softbank Investment Corporation ( SBI ) and International Stock Exchange resulting in gains of \$60.0 million. For the nine months ended September 30, 2005, our gain on sale of shares of SBI, TD AMERITRADE Holding Corporation and Archipelago Holdings, LLC was \$68.1 million.

### ***Income Tax Expense***

Income tax expense from continuing operations increased \$8.8 million or 15% and \$59.3 million or 35% during the three and nine months ended September 30, 2006 compared to the same periods in 2005. The increase in income tax expense was related to the increase in pre-tax income over the comparable periods. Our effective tax rates for the three months ended September 30, 2006 and September 30, 2005 were 30.7% and 34.5%, respectively. The effective tax rate for the three months ended September 30, 2005 included a \$2.1 million tax benefit related to the reversal of a valuation allowance related to a foreign subsidiary's net operating loss deferred tax asset. Without this event, the effective tax rate would have been 35.8% for the three months ended September 30, 2005. The decrease in the 2006 tax rate compared to the adjusted 2005 tax rate is primarily due to (i) a continued decrease in our overall effective state tax rate due to our changing geographic footprint and (ii) a \$7.6 million tax benefit arising from the favorable resolution of a tax issue related to pre-2002 earnings of a foreign subsidiary.

In prior years, we incurred significant losses in our international operations. In connection with these losses we recorded a deferred tax asset associated with the ability to carry these losses forward as a deduction against future income for income tax purposes. However, we provided a valuation allowance against a portion of this deferred tax asset since we determined that it was more likely than not that these tax benefits would not be realized. In recent periods, certain of these international operations have reached a level of profitability, which if sustained may require us to reverse all or some portion of the valuation allowance related to such international operations. The tax benefit from such a reversal would reduce our effective tax rate in the interim period in which it is recognized.

During the three months ended September 30, 2006, we filed tax returns and refund claims, which we refer to as the tax claims, in one of the tax jurisdictions in which we operate. The tax claims were filed in part as a result of recent favorable court decisions that we believe support the position taken in the tax claims. We have not yet recorded tax benefits related to the tax claims, the total amount of which could exceed \$10 million, plus applicable interest. The tax benefit from the tax claims will be recognized if and when we determine that it is probable that the benefit will be realized. However, there can be no assurance that any portion of the tax benefit will be recognized.

### ***Discontinued Operations***

Our net gain (loss) from discontinued operations was \$3.0 million and \$2.3 million for the three and nine months ended September 30, 2006, respectively. During the nine months ended September 30, 2006 and 2005, our discontinued operations included operating results from our E\*TRADE Professional Trading, LLC ( E\*TRADE Professional ) agency business and in the third quarter we recognized a gain of approximately \$2.8 million, net of tax. In the period ended September 30, 2005, discontinued operations also included operating losses from our consumer loan origination business and our E\*TRADE Professional proprietary trading business, both of which were sold or discontinued during 2005.

### ***Cumulative Effect of Accounting Change***

The cumulative effect of accounting change of \$1.6 million after tax (\$2.8 million pre-tax) for the nine months ended September 30, 2005 resulted from the adoption of SFAS No. 123(R), *Share-Based Payment* and Staff Accounting Bulletin No. 107, *Share-Based Payment*, effective July 1, 2005, which required us to record compensation expense for stock options.

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Prior to our adoption of SFAS No. 123(R), we recorded compensation expense for restricted stock awards on a straight-line basis over their vesting period. If an employee forfeited the award prior to vesting, we reversed out the previously expensed amounts in the period of forfeiture. As required upon adoption of SFAS No. 123(R), we must base the accruals of compensation expense on the estimated number of awards for which the requisite service period is expected to be rendered. Actual forfeitures are no longer recorded in the period of forfeiture. The pre-tax credit of \$2.8 million in cumulative effect of accounting change represents the amount by which compensation expense would have been reduced in periods prior to adoption of SFAS No. 123(R) for restricted stock awards outstanding on July 1, 2005 that are anticipated to be forfeited.

**SEGMENT RESULTS REVIEW****Retail**

Retail segment income increased 33% to \$145.1 million and 82% to \$511.9 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005, as shown in the following table (dollars in thousands, except for key metrics):

|   | As of or for the   |                   | Variance         |             |           | As of or for the   |                   | Variance          |             |
|---|--------------------|-------------------|------------------|-------------|-----------|--------------------|-------------------|-------------------|-------------|
|   | Three Months Ended |                   | 2006 vs. 2005    |             |           | Nine Months Ended  |                   | 2006 vs. 2005     |             |
|   | September 30, 2006 | 2005              | Amount           | %           |           | September 30, 2006 | 2005              | Amount            | %           |
| <b>Retail segment income:</b>                                 |                    |                   |                  |             |           |                    |                   |                   |             |
| Net operating interest income after provision for loan losses | \$ 221,059         | \$ 112,107        | \$ 108,952       | 97 %        | \$        | 655,685            | \$ 302,485        | \$ 353,200        | 117 %       |
| Commission  | 100,902            | 83,755            | 17,147           | 20 %        | \$        | 364,333            | 235,759           | 128,574           | 55 %        |
| Service charges and fees                                      | 28,790             | 26,933            | 1,857            | 7 %         | \$        | 83,517             | 86,683            | (3,166)           | (4)%        |
| Gain on sales of loans and securities, net                    | 10,608             | 17,534            | (6,926)          | (40)%       | \$        | 28,293             | 51,746            | (23,453)          | (45)%       |
| Other revenue   | 30,942             | 27,927            | 3,015            | 11 %        | \$        | 101,813            | 82,174            | 19,639            | 24 %        |
| <b>Net segment revenue</b>                                    | <b>392,301</b>     | <b>268,256</b>    | <b>124,045</b>   | <b>46 %</b> | <b>\$</b> | <b>1,233,641</b>   | <b>758,847</b>    | <b>474,794</b>    | <b>63 %</b> |
| <b>Total segment expense</b>                                  | <b>247,227</b>     | <b>158,936</b>    | <b>88,291</b>    | <b>56 %</b> | <b>\$</b> | <b>721,742</b>     | <b>478,279</b>    | <b>243,463</b>    | <b>51 %</b> |
| <b>Total retail segment income</b>                            | <b>\$ 145,074</b>  | <b>\$ 109,320</b> | <b>\$ 35,754</b> | <b>33 %</b> | <b>\$</b> | <b>511,899</b>     | <b>\$ 280,568</b> | <b>\$ 231,331</b> | <b>82 %</b> |

**Key Metrics:**

|   |          |          |           |       |    |         |          |           |       |
|---|----------|----------|-----------|-------|----|---------|----------|-----------|-------|
| Retail client assets (dollars in billions) <sup>(1)</sup>       | \$ 184.8 | \$ 106.4 | \$ 78.4   | 74 %  | \$ | 184.8   | \$ 106.4 | \$ 78.4   | 74 %  |
| Customer cash and deposits (dollars in billions) <sup>(1)</sup> | \$ 31.6  | \$ 19.4  | \$ 12.2   | 63 %  | \$ | 31.6    | \$ 19.4  | \$ 12.2   | 63 %  |
| DARTs   | 135,130  | 93,876   | 41,254    | 44 %  |    | 160,589 | 87,599   | 72,990    | 83 %  |
| Average commission per trade                                    | \$ 11.95 | \$ 13.94 | \$ (1.99) | (14)% | \$ | 12.10   | \$ 14.24 | \$ (2.14) | (15)% |
| Average margin receivables (dollars in billions)                | \$ 6.66  | \$ 2.27  | \$ 4.39   | 193 % | \$ | 6.76    | \$ 2.22  | \$ 4.48   | 202 % |
| Products per customer   | 2.1      | 2.0      | 0.1       | 5 %   |    | 2.1     | 2.0      | 0.1       | 5 %   |

<sup>(1)</sup> Total customer cash and deposits, as well as total retail client assets, have been re-presented to account for a methodology change in the metric to settlement date from trade date reporting as of December 31, 2005, which reduced both metrics by \$564 million.

Our retail segment generates revenue from investing, trading, banking and lending relationships with retail customers. These relationships essentially drive five sources of revenue including net operating interest income; commission; service charges and fees; gain on sales of loans and securities, net; and other revenue. This segment also includes results from our stock plan administration products and services, as we are ultimately servicing a retail customer through these corporate relationships. Our geographically dispersed retail accounts grew 20% from September 30, 2005 to September 30, 2006. As of September 30, 2006, we had approximately 3.6 million active trading and investing accounts and 0.8 million active lending and deposit accounts.

The increase in retail segment income during the three and nine months ended September 30, 2006 compared to the same periods a year ago was due to an increase in net operating interest income after provision for loan losses and commission revenue, offset by lower gains on sales of loans and securities, net. Retail net



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operating interest income after provision for loan losses increased 97% to \$221.1 million and 117% to \$655.7 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. Customer cash and deposits increased 63% at September 30, 2006 compared to September 30, 2005. Higher customer cash and deposit balances generally translate into a lower cost of funds as deposits increased in comparison to other borrowings. Average margin receivables increased 193% and 202% to \$6.7 billion and \$6.8 billion for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. Higher margin balances generally translate into a higher interest rate earned on interest-earning assets. Net operating interest income growth included the impact of the *Harrisdirect* and *BrownCo* acquisitions.

Retail commission revenue increased 20% to \$100.9 million and 55% to \$364.3 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005, due to higher volumes (DARTs), offset by lower average commission per trade. The increase in DART volumes was the result of the *Harrisdirect* and *BrownCo* acquisitions as well as strong organic growth in domestic equity, international equity and option trades.

A shift in the composition of our retail customers who traded during the period resulted in a lower average commission per trade. In addition, during the first quarter of 2006, we extended a conversion-related free trade offer to the *Harrisdirect* customer base. These factors resulted in a 14% and 15% decrease in average commission per trade for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. Due to these factors, our 44% and 83% growth in DARTs for the three and six months ended September 30, 2006 respectively, equated to a 20% and 55% increase in retail commission revenue during the three and nine months ended September 30, 2006, respectively; however, we derive revenue not only from trades but also from other aspects of our relationship with our customers, especially customers who maintain deposits and free credits with us. As such, while retail commission revenue increased 20% and 55% during the three and nine months ended September 30, 2006, total retail segment income increased 33% and 82%, respectively.

Offsetting these increases were lower gains on the sales of loans and securities, net of \$10.6 million for the three months ended September 30, 2006. In addition, service charges and fees decreased \$3.2 million for the nine months ended September 30, 2006 compared to the same period in 2005. As our overall retail customer base became more engaged with us, an increased number of those customers exceeded the minimum activity levels required to avoid account maintenance fees.

Retail segment expense increased \$88.3 million and \$243.5 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. The increase for the three months ended September 30, 2006 was primarily related to the \$16.7 million restructuring charge in the third quarter of 2006 and the \$18.1 million in increased fraud related expense as previously discussed.

**Table of Contents*****Institutional***

Institutional segment income increased 83% to \$78.1 million and 31% to \$215.8 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005, as shown in the following table (dollars in thousands, except for key metrics):

|  | As of or for the<br>Three Months Ended<br>September 30, |           | Variance<br>2006 vs. 2005 |        | As of or for the<br>Nine Months Ended<br>September 30, |            | Variance<br>2006 vs. 2005 |        |
|--|---|-----------|---------------------------|--------|--|------------|---------------------------|--------|
|  | 2006  | 2005      | Amount                    | %      | 2006   | 2005       | Amount                    | %      |
| <b>Institutional segment income:</b>                                     |   |           |                           |        |  |            |                           |        |
| Net operating interest income after provision for loan losses            | \$ 121,530  | \$ 91,997 | \$ 29,533                 | 32 %   | \$ 335,828   | \$ 272,583 | \$ 63,245                 | 23 %   |
| Commission   | 32,704  | 30,523    | 2,181                     | 7 %    | 112,438  | 87,352     | 25,086                    | 29 %   |
| Service charges and fees   | 5,120   | 5,960     | (840)                     | (14)%  | 16,023   | 13,956     | 2,067                     | 15 %   |
| Principal transactions   | 22,697  | 23,793    | (1,096)                   | (5)%   | 84,979   | 75,386     | 9,593                     | 13 %   |
| Gain on sales of loans and securities, net                               | 5,395   | 4,316     | 1,079                     | 25 %   | 10,445   | 32,375     | (21,930)                  | (68)%  |
| Other revenue  | 2,771   | 2,901     | (130)                     | (4)%   | 6,358  | 8,412      | (2,054)                   | (24)%  |
| Net segment revenue  | 190,217   | 159,490   | 30,727                    | 19 %   | 566,071  | 490,064    | 76,007                    | 16 %   |
| Total segment expense  | 112,122   | 116,823   | (4,701)                   | (4)%   | 350,262  | 325,120    | 25,142                    | 8 %    |
| Total institutional segment income                                       | \$ 78,095   | \$ 42,667 | \$ 35,428                 | 83 %   | \$ 215,809   | \$ 164,944 | \$ 50,865                 | 31 %   |
| <b>Key Metrics:</b>  |   |           |                           |        |  |            |                           |        |
| Total nonperforming loans, net as a % of gross loans held-for-investment | 0.24%   | 0.13%     | *                         | 0.11 % | 0.24%  | 0.13%      | *                         | 0.11 % |
| Average revenue capture per 1,000 equity shares                          | \$ 0.382  | \$ 0.535  | \$ (0.153)                | (29)%  | \$ 0.339   | \$ 0.434   | \$ (0.095)                | (22)%  |

\* Percentage not meaningful

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

Net operating interest income after provision for loan losses increased 32% to \$121.5 million and 23% to \$335.8 million for the three and nine months ended September 30, 2006, respectively, compared to the same periods in 2005. This increase primarily was a result of growth in interest-earning assets, which are funded primarily by retail customer cash and deposit balances. These customer balances were kept on-balance sheet as a low-cost source of funding and then utilized by the institutional segment either to purchase interest-earning assets or pay down wholesale liabilities.

The increase in institutional commissions is due to a more favorable trading environment and the continued leveraging of our integrated institutional model with higher retail order flow. We provide institutional customers with global execution and settlement services, as well as worldwide access to research provided by third parties, in exchange for commissions based on negotiated rates, which differ by customer.

The increase in net operating interest income after provision for loan losses and commission revenue was offset by a planned decrease in gain on sales of loans and securities, net. We evaluate our portfolio of securities available-for-sale in light of changing market conditions and where appropriate, take steps intended to optimize our overall economic position. Based on the current composition of our balance sheet, we determined that during the nine months ended September 30, 2006, it was not advantageous to sell securities at similar levels as the same period in the prior year.

The increase in expense for the nine months ended September 30, 2006 compared to the same period in 2005 was predominantly volume-related. Compensation and benefits expense increased due to increases in



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volume- and performance-based compensation and expensing of stock options. Clearing and servicing expense increased due to increased overall trading volumes and the increase in our loan portfolio.

**BALANCE SHEET OVERVIEW**

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

|  | September 30,        | December 31,         | Variance      |
|--|----------------------|----------------------|---------------|
|  | 2006                 | 2005                 | 2006 vs. 2005 |
| <b>Assets:</b>   |                      |                      |               |
| Cash and equivalents <sup>(1)</sup>                          | \$ 1,471,489         | \$ 1,454,362         | 1 %           |
| Trading securities   | 151,835              | 146,657              | 4 %           |
| Available-for-sale mortgage-backed and investment securities | 15,332,963           | 12,763,438           | 20 %          |
| Loans held-for-sale  | 208,633              | 87,371               | 139 %         |
| Brokerage receivables, net                                   | 7,230,960            | 7,174,175            | 1 %           |
| Loans receivable, net  | 23,215,444           | 19,424,895           | 20 %          |
| Other assets <sup>(2)</sup>                                  | 3,911,847            | 3,516,788            | 11 %          |
| <b>Total assets</b>  | <b>\$ 51,523,171</b> | <b>\$ 44,567,686</b> | <b>16 %</b>   |
| <b>Liabilities and shareholders' equity:</b>                 |                      |                      |               |
| Deposits   | \$ 22,319,364        | \$ 15,948,015        | 40 %          |
| Securities sold under agreements to repurchase               | 10,990,532           | 11,101,542           | (1)%          |
| Brokerage payables   | 7,399,279            | 7,342,208            | 1 %           |
| Other borrowings   | 4,206,922            | 4,206,996            | (0)%          |
| Corporate debt <sup>(3)</sup>                                | 1,839,835            | 2,022,701            | (9)%          |
| Accounts payable, accrued and other liabilities              | 736,982              | 546,664              | 35 %          |
| <b>Total liabilities</b>                                     | <b>47,492,914</b>    | <b>41,168,126</b>    | <b>15 %</b>   |
| <b>Shareholders' equity</b>                                  | <b>4,030,257</b>     | <b>3,399,560</b>     | <b>19 %</b>   |
| <b>Total liabilities and shareholders' equity</b>            | <b>\$ 51,523,171</b> | <b>\$ 44,567,686</b> | <b>16 %</b>   |

(1) Includes Cash and equivalents and Cash and investments required to be segregated under Federal or other regulations.

(2) Includes Property and equipment, net, Goodwill, Other intangibles, net and Other assets.

(3) Includes Senior notes, Mandatory convertible notes and Convertible subordinated notes.

During the period, we re-aligned our balance sheet to consolidate several categories and changed the name of Other borrowings by Bank subsidiary to Other borrowings. Other borrowings include non-Bank subsidiary term notes previously classified in Accounts payable, accrued and other liabilities. Categories consolidated and related changes include:

Investment in Federal Home Loan Bank stock was added to Available-for-sale mortgage-backed and investment securities ;

Derivative assets and Accrued interest receivable were added to Other assets ; and

Derivative liabilities was added to Accounts payable, accrued and other liabilities.

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These categories were consolidated with other similar items in our balance sheet presentation. The notes to our consolidated financial statements continue to include detailed information about the individual items no longer listed on the face of the balance sheet.

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The increase in total assets was primarily the result of growth in loans receivable, net and brokerage receivables, net. The growth in brokerage receivables, net was driven in part from our conversion of *Harrisdirect*

customers as well as by growth from existing and new customers. The growth in loans receivable, net was the result of our continued focus on growing our residential mortgage loan portfolios, including one- to four-family mortgages and home equity loans.

The increase in total liabilities primarily was attributable to a \$6.4 billion increase in deposits due to higher sweep deposit accounts and money market deposits resulting, in part, from our conversion of *Harrisdirect* customers, as well as from growth from existing and new customers. The increase in liabilities was partially offset by declines in securities sold under agreements to repurchase and other borrowings, which primarily was a result of our growth in deposits.

The conversion of *Harrisdirect* customers to the E\*TRADE Financial platform during the first quarter of 2006 facilitated the transfer of customer brokerage receivables, deposits and customer brokerage payables from a third party provider. Customer brokerage receivables or margin loans of \$0.8 billion were transferred to our balance sheet. In addition, sweep deposit balances of \$2.7 billion and brokerage payables, more specifically free credits, of \$1.3 billion were also moved to our balance sheet.

**Loans Receivable, Net**

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

|                                  | September 30,<br>2006 | December 31,<br>2005 | Variance<br>2006 vs. 2005 |
|----------------------------------|-----------------------|----------------------|---------------------------|
| Real estate loans:               |                       |                      |                           |
| One- to four-family              | \$ 8,912,645          | \$ 7,091,664         | 26 %                      |
| HELOC, second mortgage and other | 10,446,593            | 8,106,820            | 29 %                      |
| Consumer and other loans:        |                       |                      |                           |
| Recreational vehicle             | 2,400,979             | 2,692,055            | (11)%                     |
| Marine                           | 683,166               | 752,645              | (9)%                      |
| Credit card                      | 198,022               | 188,600              | 5 %                       |
| Automobile                       | 102,968               | 235,388              | (56)%                     |
| Other                            | 185,755               | 97,436               | 91 %                      |
| Unamortized premiums, net        | 355,224               | 323,573              | 10 %                      |
| Allowance for loan losses        | (69,908)              | (63,286)             | 10 %                      |
| Total loans receivable, net      | \$ 23,215,444         | \$ 19,424,895        | 20 %                      |

Loans receivable, net increased 20% to \$23.2 billion at September 30, 2006 from \$19.4 billion at December 31, 2005. We continue to focus our growth in real estate loans while allowing our consumer loans to decline. We anticipate that our mortgage and HELOC portfolios will continue to increase over time, and we believe this will improve our credit risk profile. We anticipate that recreational vehicle and marine loan balances will continue to decline over time due to our sale of the E\*TRADE Consumer Finance Corporation in 2005, and automobile loans will continue to decline due to our exit of the automobile origination business in 2004. Other loans include commercial loans which increased 103% to \$179.2 million during the nine months ended September 30, 2006.

**Allowance for Loan Losses**

The allowance for loan losses is management's estimate of credit losses inherent in our loan portfolio as of the balance sheet date. The estimate of the allowance for loan losses is based on a variety of factors, including the composition and quality of the portfolio; delinquency levels and trends; probable expected losses for the next

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

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

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

|                    | <b>Consumer &amp; Other</b> |                               | <b>Real Estate</b>     |                         | <b>Total</b>           |                         |
|--------------------|-----------------------------|-------------------------------|------------------------|-------------------------|------------------------|-------------------------|
|                    | <b>Allowances as %</b>      |                               | <b>Allowances as %</b> |                         | <b>Allowances as %</b> |                         |
|                    | <b>of Consumer and</b>      |                               | <b>of Real Estate</b>  |                         | <b>of Total</b>        |                         |
|                    | <b>Allowance</b>            | <b>Other Loans Receivable</b> | <b>Allowance</b>       | <b>Loans Receivable</b> | <b>Allowance</b>       | <b>Loans Receivable</b> |
| September 30, 2006 | \$ 32,845                   | 0.91%                         | \$ 37,063              | 0.19%                   | \$ 69,908              | 0.30%                   |
| June 30, 2006      | \$ 32,660                   | 0.86%                         | \$ 34,461              | 0.20%                   | \$ 67,121              | 0.32%                   |
| March 31, 2006     | \$ 33,108                   | 0.85%                         | \$ 31,401              | 0.20%                   | \$ 64,509              | 0.33%                   |
| December 31, 2005  | \$ 32,379                   | 0.80%                         | \$ 30,907              | 0.20%                   | \$ 63,286              | 0.32%                   |

The following table provides an analysis of the allowance for loan losses for the three and nine months ended September 30, 2006 and 2005 (dollars in thousands):

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2006</b>               | <b>2005</b> | <b>2006</b>              | <b>2005</b> |
| Allowance for loan losses, beginning of period | \$ 67,121                 | \$ 55,418   | \$ 63,286                | \$ 47,681   |
| Provision for loan losses                      | 12,547                    | 12,909      | 33,014                   | 37,946      |
| Charge-offs                                    | (13,950)                  | (13,037)    | (41,922)                 | (40,347)    |
| Recoveries                                     | 4,190                     | 4,564       | 15,530                   | 14,574      |
| Net charge-offs                                | (9,760)                   | (8,473)     | (26,392)                 | (25,773)    |
| Allowance for loan losses, end of period       | \$ 69,908                 | \$ 59,854   | \$ 69,908                | \$ 59,854   |

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

During the nine months ended September 30, 2006, the allowance for loan losses increased by \$6.6 million from the level at December 31, 2005. The increase primarily was due to growth in the real estate loan portfolio, which increased approximately \$4.2 billion over the same period and is not indicative of a decline in overall credit quality.

Net charge-offs for the three and nine months ended September 30, 2006 compared to the same periods in 2005 increased by \$1.3 million and \$0.6 million, respectively. The overall increase was due to higher net charge-offs on real estate loans offset by lower net charge-offs on consumer loans. The increase in real estate loan charge-offs was due to the growth of the portfolio and the decrease in consumer loan charge-offs primarily was due to a decline in loan balances as we exited the consumer finance business in 2005. Annualized net charge-offs as a percentage of average loans receivable, net were 0.17% at September 30, 2006 compared to 0.20% at September 30, 2005.



**Table of Contents***Nonperforming Assets*

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

|   | September 30, | December 31, |
|---|---------------|--------------|
|   | 2006          | 2005         |
| Real estate loans   | \$ 49,117     | \$ 27,635    |
| Consumer and other loans  | 5,785         | 7,019        |
| Total nonperforming loans, net  | 54,902        | 34,654       |
| Real estate owned ( REO ) and other repossessed assets, net                       | 9,716         | 6,555        |
| Total nonperforming assets, net   | \$ 64,618     | \$ 41,209    |
| Total nonperforming loans, net as a % of total gross loans held-for-investment    | 0.24%         | 0.18%        |
| Total allowance for loan losses as a percentage of total nonperforming loans, net | 127%          | 183%         |

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

During the nine months ended September 30, 2006, our nonperforming assets, net increased \$23.4 million from \$41.2 million at December 31, 2005. The increase is attributed to an increase in nonperforming real estate loans and REO and other repossessed assets, net of \$24.6 million, offset by a decrease in nonperforming consumer and other loans of \$1.2 million. These trends are not the result of a deterioration or improvement in credit quality, but are reflective of our targeted growth in real estate loans and the targeted decrease in consumer loans.

The allowance as a percentage of total nonperforming loans, net decreased 56% during the nine months ended September 30, 2006. As our loan portfolio shifts to mortgage loans, where the risk of charge-off is generally less than the risk of charge-off on a consumer loan, the level of the allowance to nonperforming assets may continue to decrease.

In addition to nonperforming assets in the table above, we monitor loans where a borrower's past credit history casts doubt on the borrower's ability to repay a loan, whether or not the loan is delinquent ( Special Mention loans). Special Mention loans represented \$166.9 million and \$127.2 million of the total loan portfolio at September 30, 2006 and December 31, 2005, respectively. These loans are actively monitored, continue to accrue interest and remain a component of the loans receivable balance. The increase in Special Mention loans was primarily due to an increase in the 30-day delinquency category of mortgage loans. Significant migration from this category to more serious delinquency classifications is not expected to occur.

**Table of Contents****Available-for-Sale Mortgage-Backed and Investment Securities**

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

|  | September 30,<br>2006 | December 31,<br>2005 | Variance<br>2006 vs. 2005 |
|--|-----------------------|----------------------|---------------------------|
| Mortgage-backed securities:                              |                       |                      |                           |
| Backed by U.S. government sponsored and Federal agencies | \$ 10,965,292         | \$ 9,427,521         | 16 %                      |
| Collateralized mortgage obligations and other            | 1,032,541             | 995,891              | 4 %                       |
| Total mortgage-backed securities                         | 11,997,833            | 10,423,412           | 15 %                      |
| Investment securities:                                   |                       |                      |                           |
| Asset-backed securities                                  | 2,024,935             | 1,365,754            | 48 %                      |
| Publicly traded equity securities:                       |                       |                      |                           |
| Preferred stock  | 398,388               | 288,365              | 38 %                      |
| Corporate investments                                    | 36,387                | 147,400              | (75)%                     |
| FHLB stock   | 193,750               | 198,700              | (2)%                      |
| Other  | 681,670               | 339,807              | 101 %                     |
| Total investment securities                              | 3,335,130             | 2,340,026            | 43 %                      |
| Total available-for-sale securities                      | \$ 15,332,963         | \$ 12,763,438        | 20 %                      |

Available-for-sale securities represented 30% and 29% of total assets at September 30, 2006 and December 31, 2005, respectively.

Available-for-sale securities increased to \$15.3 billion at September 30, 2006, primarily due to the growth in our mortgage-backed and asset-backed securities portfolio. We evaluate our available-for-sale securities in light of changing market conditions and other factors and, where appropriate, take steps intended to improve our overall position. Based on this evaluation, we decided to grow our mortgage-backed and asset-backed securities portfolio during the current period.

As interest rates increase, the fair value of fixed-rate available-for-sale securities decreases and vice versa. The fair value of the portfolio will be adversely impacted in 2006 if long-term interest rates continue to rise. Net unrealized gains and losses in available-for-sale securities are included in shareholders' equity as accumulated other comprehensive income or loss, net of tax.

**Deposits**

Deposits are summarized as follows (dollars in thousands):

|                                   | September 30,<br>2006 | December 31,<br>2005 | Variance<br>2006 vs. 2005 |
|-----------------------------------|-----------------------|----------------------|---------------------------|
| Sweep deposit accounts            | \$ 10,351,653         | \$ 7,733,267         | 34 %                      |
| Money market and savings accounts | 6,391,190             | 4,635,866            | 38 %                      |
| Certificates of deposit           | 4,649,385             | 2,703,605            | 72 %                      |
| Brokered certificates of deposit  | 566,988               | 484,612              | 17 %                      |
| Checking accounts                 | 360,148               | 390,665              | (8)%                      |
| Total deposits                    | \$ 22,319,364         | \$ 15,948,015        | 40 %                      |

Deposits represented 47% and 39% of total liabilities at September 30, 2006 and December 31, 2005, respectively. Deposits increased \$6.4 billion to \$22.3 billion at September 30, 2006, driven by a \$2.6 billion increase in sweep deposit accounts, a \$1.8 billion increase in money market and savings accounts and a \$1.9 billion increase in certificates of deposit.

The increase in sweep deposit accounts was driven primarily by the *Harrisdirect* and BrownCo conversions. Prior to the conversions, *Harrisdirect* customer cash balances were swept to a third party and not reflected on our

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balance sheet, and BrownCo customer cash balances were generally kept in free credits. Our other deposit products have shown significant growth as a result of our focused sales and retention efforts, as well as the overall impact of the E\*TRADE Complete Intelligent Cash Optimizer. E\*TRADE Complete Intelligent Cash Optimizer enables customers to better determine the optimal use of their funds and has resulted in higher money market and certificates of deposit balances. The sweep deposit accounts, money market accounts and certificates of deposit generally provide us the benefit of lower interest costs, compared with wholesale funding alternatives.

The deposits balance is a component of the total customer cash and deposits balance reported as a customer activity metric of \$31.6 billion for the three and nine months ended September 30, 2006. The total customer cash and deposits balance is summarized as follows (dollars in thousands):

|   | September 30,<br>2006 | December 31,<br>2005 | Variance<br>2006 vs. 2005 |
|---|-----------------------|----------------------|---------------------------|
| Deposits  | \$ 22,319,364         | \$ 15,948,015        | 40 %                      |
| Less: brokered certificates of deposit              | (566,988)             | (484,612)            | 17 %                      |
| Deposits excluding brokered certificates of deposit | 21,752,376            | 15,463,403           | 41 %                      |
| Free credits  | 6,156,438             | 5,770,751            | 7 %                       |
| Customer cash balances held by third parties        | 3,702,356             | 6,955,830            | (47)%                     |
| Total customer cash and deposits                    | \$ 31,611,170         | \$ 28,189,984        | 12 %                      |

**Corporate Debt**

Corporate debt decreased to \$1.8 billion at September 30, 2006 compared to \$2.0 billion at December 31, 2005. The Company called the remaining \$185.2 million principal amount of its 6.00% convertible subordinated notes due February 2007 (the 6.00% Notes ) during the nine months ended September 30, 2006. See Liquidity and Capital Resources Corporate Debt below.

**LIQUIDITY AND CAPITAL RESOURCES**

Our liquidity and capital resources enable us to fund our operating activities, finance acquisitions and grow our assets. Cash flows are derived from capital market activities and our operations in the retail and institutional segments. The segment cash flows provide capital to fund growth in our regulated subsidiaries. The Company's cash and equivalents balance increased to \$1.2 billion for the period ended September 30, 2006.

**Corporate Debt**

During the nine months ended September 30, 2006, the Company called the remaining \$185.2 million principal amount of its 6.00% convertible subordinated notes due February 2007 (the 6.00% Notes ). In April 2006, the Company completed the partial redemption that was originally announced in March 2006 and called the remaining \$92.6 million principal amount of its 6.00% Notes. The table below shows the timing and impact of these calls (dollars and shares in millions):

|  | Debt<br>Redeemed | Common<br>Stock<br>Shares<br>Issued | Cash<br>Paid |
|--|------------------|-------------------------------------|--------------|
| First call in March 2006                 |                  |                                     |              |
| March redemptions                        | \$ 36.3          | 1.5                                 | \$           |
| April redemptions                        | 56.3             | 2.4                                 | 0.9          |
| Second call in April 2006 <sup>(1)</sup> | 92.6             | 3.9                                 | 0.9          |
| Total redemptions                        | \$ 185.2         | 7.8                                 | \$ 1.8       |

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(1) All redemptions occurred in April.

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

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

Liquidity available to the Company from its subsidiaries, other than Converging Arrows, Inc. (Converging Arrows), is limited by regulatory requirements. Converging Arrows is a subsidiary of the parent company. At September 30, 2006, Converging Arrows had \$154.0 million of cash and investment securities available as a source of liquidity for the parent company. Converging Arrows is not restricted in its dealings with the parent company and may transfer funds to the parent company without regulatory approval. In addition to Converging Arrows, brokerage and banking subsidiaries may provide liquidity to the parent; however, they are restricted by regulatory guidelines.

The Bank is prohibited by regulations from lending to the parent company. At September 30, 2006, the Bank had approximately \$151.5 million of capital available for dividend declaration without regulatory approval while still maintaining well capitalized status. The Bank is also required by Office of Thrift Supervision (OTS) regulations to maintain tangible capital of at least 1.50% of tangible assets. The Bank satisfied this requirement at September 30, 2006 and December 31, 2005.

Brokerage subsidiaries are required to maintain net capital equal to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions. At September 30, 2006 and December 31, 2005, all of our brokerage subsidiaries met their minimum net capital requirements. The Company's broker-dealer subsidiaries had excess net capital of \$669.8 million at September 30, 2006.

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

We maintain committed and uncommitted financing facilities with banks totaling \$550.0 million to meet corporate liquidity needs and finance margin lending. There were no outstanding balances and the full \$550.0 million was available under these lines at September 30, 2006 and December 31, 2005.

We rely on borrowed funds, such as FHLB advances and securities sold under agreements to repurchase to provide liquidity for the Bank. At September 30, 2006, the Bank had approximately \$8.2 billion in additional borrowing capacity.

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

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

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

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon the financial results of the Company. We believe that of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: allowance for loan losses and uncollectible margin loans; classification and valuation of certain investments; valuation and accounting for financial derivatives; estimates of effective tax rate; deferred taxes and valuation allowances; and valuation of goodwill and other intangibles. These are more fully described in

Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2005.

**Table of Contents****REQUIRED FINANCIAL DATA**

This section provides an update to information presented in our Form 10-K required by the SEC's Industry Guide 3, *Statistical Disclosure by Bank Holding Companies* that has not been incorporated elsewhere into Management's Discussion and Analysis. The table in this section includes Bank subsidiary information only.

***Distribution of Assets, Liabilities and Shareholder's Equity; Interest Rates and Operating Interest Differential***

The following tables present average balance data and income and expense data for our banking operations, as well as the related interest yields and rates and interest spread (dollars in thousands):

|   | Three Months Ended September 30, |  |                       |                 |  |                       |
|---|----------------------------------|--|-----------------------|-----------------|--|-----------------------|
|   | Average Balance                  | 2006<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/Cost | Average Balance | 2005<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/Cost |
| Interest-earning banking assets:  |                                  |  |                       |                 |  |                       |
| Loans, net <sup>(1)</sup>   | \$ 22,955,022                    | \$ 364,744                                 | 6.36%                 | \$ 17,024,600   | \$ 232,004                                 | 5.45%                 |
| Mortgage-backed and related available-for-sale securities   | 12,068,052                       | 159,199                                    | 5.28%                 | 9,059,130       | 97,537                                     | 4.31%                 |
| Available-for-sale investment securities  | 3,220,054                        | 51,885                                     | 6.44%                 | 1,937,276       | 25,888                                     | 5.35%                 |
| Trading securities  | 114,806                          | 2,600                                      | 9.06%                 | 186,377         | 2,792                                      | 5.99%                 |
| Other   | 44,209                           | 571  | 5.12%                 | 95,714          | 719  | 2.98%                 |
| Total interest-earning banking assets <sup>(2)</sup>  | 38,402,143                       | 578,999                                    | 6.03%                 | 28,303,097      | 358,940                                    | 5.07%                 |
| Non-interest-earning banking assets   | 522,228                          |  |                       | 528,215         |  |                       |
| Total banking assets  | \$ 38,924,371                    |  |                       | \$ 28,831,312   |  |                       |
| Interest-bearing banking liabilities:   |                                  |  |                       |                 |  |                       |
| Retail deposits   | \$ 20,992,962                    | 141,035                                    | 2.67%                 | \$ 13,095,471   | 57,710                                     | 1.75%                 |
| Brokered certificates of deposit  | 618,681                          | 7,453                                      | 4.78%                 | 540,575         | 4,815                                      | 3.53%                 |
| Repurchase agreements and other borrowings  | 11,586,260                       | 150,837                                    | 5.09%                 | 9,510,214       | 91,520                                     | 3.77%                 |
| FHLB advances   | 3,583,663                        | 43,950                                     | 4.80%                 | 4,093,294       | 40,914                                     | 3.91%                 |
| Total interest-bearing banking liabilities  | 36,781,566                       | 343,275                                    | 3.67%                 | 27,239,554      | 194,959                                    | 2.84%                 |
| Non-interest-bearing banking liabilities  | 314,091                          |  |                       | 273,685         |  |                       |
| Total banking liabilities   | 37,095,657                       |  |                       | 27,513,239      |  |                       |
| Total banking shareholder's equity  | 1,828,714                        |  |                       | 1,318,073       |  |                       |
| Total banking liabilities and shareholder's equity  | \$ 38,924,371                    |  |                       | \$ 28,831,312   |  |                       |
| Excess of interest-earning banking assets over interest-bearing banking liabilities/net operating interest income | \$ 1,620,577                     | \$ 235,724                                 |                       | \$ 1,063,543    | \$ 163,981                                 |                       |
| Bank net operating interest:  |                                  |  |                       |                 |  |                       |
| Spread  |                                  |  | 2.36%                 |                 |  | 2.23%                 |
| Margin (net yield on interest-earning banking assets)   |                                  |  | 2.46%                 |                 |  | 2.32%                 |
| Ratio of interest-earning banking assets to interest-bearing banking liabilities                                  |                                  |  | 104.41%               |                 |  | 103.90%               |
| Return on average: <sup>(3)(4)</sup>  |                                  |  |                       |                 |  |                       |
| Total banking assets  |                                  |  | 1.03%                 |                 |  | 0.96%                 |
| Total banking shareholder's equity  |                                  |  | 21.87%                |                 |  | 21.06%                |
| Average equity to average total banking assets  |                                  |  | 4.70%                 |                 |  | 4.57%                 |

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- (1) Nonaccrual loans are included in the respective average loan balances. Income on such nonaccrual loans is recognized on a cash basis.
  - (2) Amount includes a taxable equivalent increase in operating interest income of \$5.3 million and \$2.6 million for the three months ended September 30, 2006 and 2005, respectively.
  - (3) Ratio calculations exclude discontinued operations.
  - (4) Ratio calculations are based on stand alone Bank results.

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|   | Nine Months Ended September 30, |  |                       |                    |  |                       |
|---|---------------------------------|--|-----------------------|--------------------|--|-----------------------|
|   | Average<br>Balance              | 2006<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/Cost | Average<br>Balance | 2005<br>Operating<br>Interest<br>Inc./Exp. | Average<br>Yield/Cost |
| Interest-earning banking assets:  |                                 |  |                       |                    |  |                       |
| Loans, net <sup>(1)</sup>   | \$ 20,994,403                   | \$ 949,513                                 | 6.03%                 | \$ 14,517,416      | \$ 569,191                                 | 5.23%                 |
| Mortgage-backed and related available-for-sale securities   | 11,451,932                      | 432,077                                    | 5.03%                 | 9,139,878          | 285,366                                    | 4.16%                 |
| Available-for-sale investment securities  | 2,931,914                       | 136,561                                    | 6.21%                 | 2,957,416          | 112,115                                    | 5.05%                 |
| Trading securities  | 131,885                         | 8,194                                      | 8.28%                 | 308,240            | 9,631                                      | 4.17%                 |
| Other   | 46,489                          | 1,561                                      | 4.44%                 | 57,363             | 1,095                                      | 2.56%                 |
| Total interest-earning banking assets <sup>(2)</sup>  | 35,556,623                      | 1,527,906                                  | 5.73%                 | 26,980,313         | 977,398                                    | 4.83%                 |
| Non-interest-earning banking assets   | 487,802                         |  |                       | 467,642            |  |                       |
| Total banking assets  | \$ 36,044,425                   |  |                       | \$ 27,447,955      |  |                       |
| Interest-bearing banking liabilities:   |                                 |  |                       |                    |  |                       |
| Retail deposits   | \$ 19,664,315                   | 346,602                                    | 2.36%                 | \$ 12,407,871      | 147,570                                    | 1.59%                 |
| Brokered certificates of deposit  | 539,508                         | 18,262                                     | 4.53%                 | 429,568            | 10,818                                     | 3.37%                 |
| Repurchase agreements and other borrowings  | 10,680,195                      | 391,460                                    | 4.83%                 | 9,995,414          | 261,492                                    | 3.45%                 |
| FHLB advances   | 3,161,930                       | 108,696                                    | 4.53%                 | 3,026,553          | 86,358                                     | 3.76%                 |
| Total interest-bearing banking liabilities  | 34,045,948                      | 865,020                                    | 3.37%                 | 25,859,406         | 506,238                                    | 2.62%                 |
| Non-interest-bearing banking liabilities  | 303,307                         |  |                       | 320,168            |  |                       |
| Total banking liabilities   | 34,349,255                      |  |                       | 26,179,574         |  |                       |
| Total banking shareholder's equity  | 1,695,170                       |  |                       | 1,268,381          |  |                       |
| Total banking liabilities and shareholder's equity  | \$ 36,044,425                   |  |                       | \$ 27,447,955      |  |                       |
| Excess of interest-earning banking assets over interest-bearing banking liabilities/net operating interest income | \$ 1,510,675                    | \$ 662,886                                 |                       | \$ 1,120,907       | \$ 471,160                                 |                       |
| Bank net operating interest:  |                                 |  |                       |                    |  |                       |
| Spread  |                                 |  | 2.36%                 |                    |  | 2.21%                 |
| Margin (net yield on interest-earning banking assets)   |                                 |  | 2.49%                 |                    |  | 2.33%                 |
| Ratio of interest-earning banking assets to interest-bearing banking liabilities                                  |                                 |  | 104.44%               |                    |  | 104.33%               |
| Return on average: <sup>(3)(4)</sup>  |                                 |  |                       |                    |  |                       |
| Total banking assets  |                                 |  | 1.02%                 |                    |  | 0.99%                 |
| Total banking shareholder's equity  |                                 |  | 21.63%                |                    |  | 21.43%                |
| Average equity to average total banking assets  |                                 |  | 4.70%                 |                    |  | 4.62%                 |

(1) Nonaccrual loans are included in the respective average loan balances. Income on such nonaccrual loans is recognized on a cash basis.

(2) Amount includes a taxable equivalent increase in operating interest income of \$12.9 million and \$7.9 million for the nine months ended September 30, 2006 and 2005, respectively.

(3) Ratio calculations exclude discontinued operations.

(4) Ratio calculations are based on stand alone Bank results.

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### **GLOSSARY OF TERMS**

*Active Trader* The customer segment that includes those who execute 30 or more trades per quarter and have base pricing of \$6.99 to \$9.99 per trade.

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

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

*Average equity to total banking assets* Average total banking shareholder's equity divided by average total banking assets.

*Basis point* One hundredth of a percentage point.

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

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

*Clearing and servicing expense* A predominantly variable expense associated with our trading products and the servicing expense associated with our loan products.

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

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

*Customer cash and deposits* Customer cash, deposits, free credits and money market balances, including those held by third parties.

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

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

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

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

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

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

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

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

*Free credits* Balances held in Brokerage customer accounts arising from deposits of funds and sales of securities.

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

*Interest-bearing banking liabilities* Liabilities such as customer deposits, repurchase agreements, other borrowings and advances from the FHLB on which the Company pays interest.

*Interest-earning banking assets* Assets such as loans receivable, mortgage-backed and available-for-sale securities, trading securities and cash that earn interest for the Company.

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

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

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

*Main Street Investor* The customer segment that includes those who execute less than 30 trades per quarter, hold less than \$50,000 in assets in combined retail accounts and have base pricing of \$12.99 per trade

*Margin loans* The extension of credit to brokerage customers of the Company, where the loan is secured with securities owned by the customer.

*Mass Affluent* The customer segment that includes those who execute less than 30 trades per quarter, hold \$50,000 or more in assets in combined retail accounts and have base pricing of \$9.99 per trade.

*Net interest spread* The difference between the weighted-average yields earned on interest-earning assets and the weighted-average yields paid on interest-bearing liabilities.

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

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

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

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

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

*Organic* Business related to new and existing customers as opposed to acquisitions (referred to as *core* in previous filings).

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

*Product* An account feature that generates revenue, such as a margin enabled account, or an account function that creates a deeper customer relationship, such as *Bill Pay*.

*Products per customer* Average number of our products that a customer actively uses.

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

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

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

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

*Return on average total banking shareholder 's equity* Annualized Bank net income from continuing operations divided by average banking shareholder 's equity.

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

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

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

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

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

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

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

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

The following discussion about our market risk disclosure includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005 and as updated in this report. Market risk is our exposure to changes in interest rates, foreign exchange rates and equity and commodity prices. Our exposure to interest rate risk is primarily related to interest-earning assets and interest-bearing liabilities.

#### ***Interest Rate Risk***

The management of interest rate risk is essential to profitability. Interest rate risk is our exposure to changes in interest rates. In general, we manage our interest rate risk by balancing variable-rate and fixed-rate assets, liabilities and derivatives in a way that reduces our overall exposure to changes in interest rates. This analysis is based on complex assumptions regarding maturities, market interest rates and customer behavior. Changes in interest rates, including the following, could impact interest income and expense:

Interest-earning assets and interest-bearing liabilities may re-price at different times or by different amounts creating a mismatch.

The yield curve may flatten or change shape affecting the spread between short- and long-term rates. Widening or narrowing spreads could impact net interest income.

Market interest rates may influence prepayments resulting in maturity mismatches. In addition, prepayments could impact yields as premium and discounts amortize.

Exposure to market risk is dependent upon the distribution and composition of interest-earning assets, interest-bearing liabilities and derivatives. The differing risk characteristics of each product are managed to mitigate our exposure to interest rate fluctuations. At September 30, 2006, 92% of our total assets were interest-earning assets.

At September 30, 2006, approximately 60% of our total assets were residential mortgages and mortgage-backed securities. The values of these assets are sensitive to changes in interest rates, as well as expected prepayment levels. As interest rates increase, fixed rate residential mortgages and mortgage-backed securities tend to exhibit lower prepayments. The inverse is true in a falling rate environment.

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

#### ***Derivative Financial Instruments***

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

**Table of Contents****Scenario Analysis**

Scenario analysis is an advanced approach to estimating interest rate risk exposure. Under the Net Present Value of Equity ( NPVE ) approach, the present value of all existing assets, liabilities, derivatives and forward commitments are estimated and then combined to produce a NPVE figure. The sensitivity of this value to changes in interest rates is then determined by applying alternative interest rate scenarios, which include, but are not limited to, instantaneous parallel shifts up 100, 200 and 300 basis points and down 100 and 200 basis points. The NPVE method is used at the Bank level and not for the Company. The Bank has 82% and 79% of our interest-earning assets at September 30, 2006 and December 31, 2005, respectively, and holds 80% and 77% of our interest-bearing liabilities at September 30, 2006 and December 31, 2005, respectively. Interest-earning assets not included in the NPVE approach are floating-rate brokerage receivables and a small portfolio of trading securities. Interest-bearing liabilities not currently included in the analysis consist of brokerage payables and corporate level long-term debt.

The sensitivity of NPVE at September 30, 2006 and December 31, 2005 and the limits established by the Bank's Board of Directors are listed below (dollars in thousands):

| Parallel Change in<br>Interest Rates (bps) | Change in NPVE     |            |                   |            |             |
|--|--------------------|------------|-------------------|------------|-------------|
|  | September 30, 2006 |            | December 31, 2005 |            | Board Limit |
|  | Amount             | Percentage | Amount            | Percentage |             |
| +300                                       | \$ 204,416         | 8 %        | \$ (490,045)      | (22)%      | (55)%       |
| +200                                       | \$ 133,791         | 5 %        | \$ (298,476)      | (13)%      | (30)%       |
| +100                                       | \$ 59,343          | 2 %        | \$ (115,244)      | (5)%       | (20)%       |
| 100  | \$ (181,402)       | (7)%       | \$ (49,256)       | (2)%       | (20)%       |
| 200  | \$ (586,807)       | (24)%      | \$ (382,924)      | (17)%      | (30)%       |

Under criteria published by the Office of Thrift Supervision, the Bank's overall interest rate risk exposure at September 30, 2006 was characterized as moderate. We actively manage our interest rate risk positions. As interest rates change, we will re-adjust our strategy and mix of assets, liabilities and derivatives to optimize our position. For example, a 100 basis points increase in rates may not result in a change in value as indicated above. The Bank's Asset Liability Committee monitors the Bank's interest rate risk position.

**Mortgage Production Activities**

Our current strategy is to retain more originated mortgage loans on the balance sheet, thus reducing current period income related to the sales of these loans. Holding mortgage assets on the balance sheet involves risks including exposure to interest rate fluctuations between the commitment and funding dates and prepayment risk. When mortgage loans prepay, mortgage origination costs are written off. Depending on the timing of the prepayment, these write-offs may result in lower than anticipated yields. The Bank's Asset Liability Committee reviews estimates of the impact of changing market rates on loan production volumes and prepayments. This information is incorporated into our interest rate risk management strategy.

For mortgage loans intended to be sold, Interest Rate Lock Commitments ( IRLCs ) are considered derivatives with changes in fair value recorded in earnings. IRLCs are commitments issued to borrowers that lock in an interest rate now for a loan closing in one to three months. These locks, initially recorded with a fair value of zero, will fluctuate in value during the lock period as market interest rates change. IRLCs were valued as a \$0.5 million and \$1.6 million asset at September 30, 2006 and December 31, 2005, respectively.

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF INCOME****(In thousands, except per share amounts)****(Unaudited)**

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |              |
|---|---|-------------|--|--------------|
|   | <b>2006</b>                                 | <b>2005</b> | <b>2006</b>                                | <b>2005</b>  |
| Revenue:  |   |             |  |              |
| Operating interest income   | \$ 731,429                                  | \$ 424,114  | \$ 1,986,096                               | \$ 1,148,384 |
| Operating interest expense  | (376,293)                                   | (207,101)   | (961,569)                                  | (535,532)    |
| Net operating interest income   | 355,136                                     | 217,013     | 1,024,527                                  | 612,852      |
| Provision for loan losses   | (12,547)                                    | (12,909)    | (33,014)                                   | (37,946)     |
| Net operating interest income after provision for loan losses   | 342,589                                     | 204,104     | 991,513                                    | 574,906      |
| Commission  | 133,606                                     | 114,278     | 476,771                                    | 323,111      |
| Service charges and fees  | 33,910                                      | 32,893      | 99,540                                     | 100,639      |
| Principal transactions  | 22,697                                      | 23,793      | 84,979                                     | 75,547       |
| Gain on sales of loans and securities, net  | 16,003                                      | 21,850      | 38,738                                     | 84,121       |
| Other revenue   | 32,961                                      | 22,918      | 99,932                                     | 66,596       |
| Total non-interest income   | 239,177                                     | 215,732     | 799,960                                    | 650,014      |
| Total net revenue   | 581,766                                     | 419,836     | 1,791,473                                  | 1,224,920    |
| Expense excluding interest:   |   |             |  |              |
| Compensation and benefits   | 110,705                                     | 103,084     | 352,334                                    | 280,472      |
| Clearing and servicing  | 62,500                                      | 46,930      | 189,926                                    | 132,720      |
| Advertising and market development  | 23,914                                      | 21,188      | 89,115                                     | 74,252       |
| Communications  | 25,576                                      | 18,210      | 84,818                                     | 54,650       |
| Professional services   | 20,741                                      | 16,703      | 71,715                                     | 53,168       |
| Depreciation and amortization   | 18,565                                      | 18,443      | 56,181                                     | 53,310       |
| Occupancy and equipment   | 22,150                                      | 16,249      | 63,082                                     | 50,673       |
| Amortization of other intangibles   | 12,087                                      | 4,382       | 35,391                                     | 13,751       |
| Facility restructuring and other exit activities  | 16,684                                      | (469)       | 19,315                                     | 495          |
| Other   | 45,675                                      | 23,129      | 101,888                                    | 65,917       |
| Total expense excluding interest  | 358,597                                     | 267,849     | 1,063,765                                  | 779,408      |
| Income before other income (expense), income taxes, minority interest, discontinued operations and cumulative effect of accounting change | 223,169                                     | 151,987     | 727,708                                    | 445,512      |
| Other income (expense):   |   |             |  |              |
| Corporate interest income   | 1,942                                       | 3,409       | 6,091                                      | 7,796        |
| Corporate interest expense  | (37,964)                                    | (13,783)    | (114,586)                                  | (36,975)     |
| Gain on sales and impairment of investments   | 26,991                                      | 22,028      | 59,897                                     | 68,172       |
| Loss on early extinguishment of debt  |   |             | (703)                                      |              |
| Equity in income of investments and venture funds   | 2,519                                       | 3,103       | 1,701                                      | 7,142        |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Total other income (expense)  | (6,512)    | 14,757     | (47,600)   | 46,135     |
| Income before income taxes, minority interest, discontinued operations and cumulative effect of accounting change | 216,657    | 166,744    | 680,108    | 491,647    |
| Income tax expense  | 66,429     | 57,606     | 230,204    | 170,862    |
| Minority interest in subsidiaries   |            |            |            | 58         |
| Net income from continuing operations   | 150,228    | 109,138    | 449,904    | 320,727    |
| Discontinued operations, net of tax:  |            |            |            |            |
| Loss from discontinued operations   |            | (3,464)    | (721)      | (18,901)   |
| Gain (loss) on disposal of discontinued operations  | 3,021      | 171        | 3,021      | (2,420)    |
| Gain (loss) from discontinued operations, net of tax  | 3,021      | (3,293)    | 2,300      | (21,321)   |
| Cumulative effect of accounting change, net of tax  |            | 1,646      |            | 1,646      |
| Net income  | \$ 153,249 | \$ 107,491 | \$ 452,204 | \$ 301,052 |
| Basic earnings per share from continuing operations   | \$ 0.35    | \$ 0.30    | \$ 1.07    | \$ 0.88    |
| Basic earnings (loss) per share from discontinued operations  | 0.01       | (0.01)     | 0.01       | (0.06)     |
| Basic earnings per share from cumulative effect of accounting change  |            | 0.00       |            | 0.00       |
| Basic net earnings per share  | \$ 0.36    | \$ 0.29    | \$ 1.08    | \$ 0.82    |
| Diluted earnings per share from continuing operations   | \$ 0.34    | \$ 0.29    | \$ 1.03    | \$ 0.85    |
| Diluted earnings (loss) per share from discontinued operations  | 0.01       | (0.01)     | 0.00       | (0.06)     |
| Diluted income per share from cumulative effect of accounting change  |            | 0.00       |            | 0.00       |
| Diluted net earnings per share  | \$ 0.35    | \$ 0.28    | \$ 1.03    | \$ 0.79    |
| Shares used in computation of per share data:   |            |            |            |            |
| Basic   | 423,736    | 367,342    | 420,148    | 366,215    |
| Diluted   | 438,883    | 382,031    | 436,959    | 379,768    |

See accompanying notes to consolidated financial statements

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

|  | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|--|-------------------------------|------------------------------|
| <b><u>ASSETS</u></b>   |                               |                              |
| Cash and equivalents   | \$ 1,199,638                  | \$ 844,188                   |
| Cash and investments required to be segregated under Federal or other regulations  | 271,851                       | 610,174                      |
| Trading securities   | 151,835                       | 146,657                      |
| Available-for-sale mortgage-backed and investment securities (includes securities pledged to creditors with the right to sell or repledge of \$11,819,049 at September 30, 2006 and \$11,792,684 at December 31, 2005) | 15,332,963                    | 12,763,438                   |
| Loans held-for-sale  | 208,633                       | 87,371                       |
| Brokerage receivables, net   | 7,230,960                     | 7,174,175                    |
| Loans receivable, net (net of allowance for loan losses of \$69,908 at September 30, 2006 and \$63,286 at December 31, 2005)   | 23,215,444                    | 19,424,895                   |
| Property and equipment, net  | 299,261                       | 299,256                      |
| Goodwill   | 2,063,598                     | 2,003,456                    |
| Other intangibles, net   | 498,743                       | 532,108                      |
| Other assets   | 1,050,245                     | 681,968                      |
| <b>Total assets</b>  | <b>\$ 51,523,171</b>          | <b>\$ 44,567,686</b>         |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>   |                               |                              |
| <b>Liabilities:</b>  |                               |                              |
| Deposits   | \$ 22,319,364                 | \$ 15,948,015                |
| Securities sold under agreements to repurchase   | 10,990,532                    | 11,101,542                   |
| Brokerage payables   | 7,399,279                     | 7,342,208                    |
| Other borrowings   | 4,206,922                     | 4,206,996                    |
| Senior notes   | 1,400,505                     | 1,401,947                    |
| Mandatory convertible notes  | 439,330                       | 435,589                      |
| Convertible subordinated notes   |                               | 185,165                      |
| Accounts payable, accrued and other liabilities  | 736,982                       | 546,664                      |
| <b>Total liabilities</b>   | <b>47,492,914</b>             | <b>41,168,126</b>            |
| <b>Shareholders' equity:</b>   |                               |                              |
| Common stock, \$0.01 par value, shares authorized: 600,000,000; shares issued and outstanding: 427,007,278 at September 30, 2006 and 416,582,164 at December 31, 2005  | 4,270                         | 4,166                        |
| Additional paid-in capital ( APIC )  | 3,203,450                     | 2,990,676                    |
| Retained earnings  | 1,032,634                     | 580,430                      |
| Accumulated other comprehensive loss   | (210,097)                     | (175,712)                    |
| <b>Total shareholders' equity</b>  | <b>4,030,257</b>              | <b>3,399,560</b>             |
| <b>Total liabilities and shareholders' equity</b>  | <b>\$ 51,523,171</b>          | <b>\$ 44,567,686</b>         |

See accompanying notes to consolidated financial statements

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

|  | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2006</b>                                 | <b>2005</b> | <b>2006</b>                                | <b>2005</b> |
| Net income   | \$ 153,249                                  | \$ 107,491  | \$ 452,204                                 | \$ 301,052  |
| Other comprehensive loss   |   |             |  |             |
| Available-for-sale securities:   |   |             |  |             |
| Unrealized gains (losses), net   | 156,018                                     | (19,961)    | (25,873)                                   | 23,044      |
| Less impact of realized gains (transferred out of accumulated other comprehensive income) and included in net income, net                                | (38,291)                                    | (14,066)    | (65,814)                                   | (61,552)    |
| Net change from available-for-sale securities  | 117,727                                     | (34,027)    | (91,687)                                   | (38,508)    |
| Cash flow hedging instruments:   |   |             |  |             |
| Unrealized gains (losses), net   | (107,665)                                   | 83,027      | 43,078                                     | (15,384)    |
| Amortization of losses into operating interest expense related to de-designated cash flow hedges deferred in accumulated other comprehensive income, net | 827   | 8,622       | 5,907                                      | 34,271      |
| Net change from cash flow hedging instruments  | (106,838)                                   | 91,649      | 48,985                                     | 18,887      |
| Foreign currency translation gains (losses)  | 2,740                                       | (2,631)     | 8,317                                      | (17,119)    |
| Other comprehensive income (loss)  | 13,629                                      | 54,991      | (34,385)                                   | (36,740)    |
| Comprehensive income   | \$ 166,878                                  | \$ 162,482  | \$ 417,819                                 | \$ 264,312  |

See accompanying notes to consolidated financial statements

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

|   | Shares Exchangeable<br>into Common<br>Stock |        | Common Stock |          | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders'<br>Equity |
|---|---|--------|--------------|----------|----------------------------------|----------------------|---|----------------------------------|
|   | Shares                                      | Amount | Shares       | Amount   |                                  |                      |   |                                  |
| Balance, December 31, 2005  |   | \$     | 416,582      | \$ 4,166 | \$ 2,990,676                     | \$ 580,430           | \$ (175,712)                                  | \$ 3,399,560                     |
| Net income  |   |        |              |          |                                  | 452,204              |   | 452,204                          |
| Other comprehensive loss  |   |        |              |          |                                  |                      | (34,385)                                      | (34,385)                         |
| Exercise of stock options and<br>warrants, including tax benefit                |   |        | 4,911        | 49       | 66,897                           |                      |   | 66,946                           |
| Issuance of common stock upon<br>conversion of 6% convertible debt              |   |        | 7,772        | 78       | 183,333                          |                      |   | 183,411                          |
| Issuance of common stock upon<br>acquisition                                    |   |        | 847          | 8        | 19,742                           |                      |   | 19,750                           |
| Repurchases of common stock   |   |        | (3,543)      | (35)     | (82,739)                         |                      |   | (82,774)                         |
| Issuance of restricted stock  |   |        | 620          | 6        | (6)                              |                      |   |                                  |
| Cancellation of restricted stock  |   |        | (98)         | (1)      | 1                                |                      |   |                                  |
| Retirement of restricted stock to pay<br>taxes                                  |   |        | (84)         | (1)      | (2,001)                          |                      |   | (2,002)                          |
| Amortization of deferred stock<br>compensation to APIC under SFAS<br>No. 123(R) |   |        |              |          | 27,618                           |                      |   | 27,618                           |
| Other   |   |        |              |          | (71)                             |                      |   | (71)                             |
| Balance, September 30, 2006   |   | \$     | 427,007      | \$ 4,270 | \$ 3,203,450                     | \$ 1,032,634         | \$ (210,097)                                  | \$ 4,030,257                     |

|   | Shares Exchangeable<br>into Common Stock |        | Common Stock |          | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders'<br>Equity |
|---|--|--------|--------------|----------|----------------------------------|----------------------|---|----------------------------------|
|   | Shares                                   | Amount | Shares       | Amount   |                                  |                      |   |                                  |
| Balance, December 31, 2004  | 1,303                                    | \$ 13  | 369,624      | \$ 3,696 | \$ 2,215,674                     | \$ 150,018           | \$ (141,199)                                  | \$ 2,228,202                     |
| Net income  |  |        |              |          |                                  | 301,052              |   | 301,052                          |
| Other comprehensive loss  |  |        |              |          |                                  |                      | (36,740)                                      | (36,740)                         |
| Exercise of stock options and warrants,<br>including tax benefit  |  |        | 7,302        | 73       | 68,483                           |                      |   | 68,556                           |
| Issuance of common stock upon<br>acquisition  |  |        | 300          | 3        | 4,038                            |                      |   | 4,041                            |
| Repurchases of common stock   |  |        | (4,548)      | (45)     | (58,170)                         |                      |   | (58,215)                         |
| Issuance of restricted stock  |  |        | 830          | 8        | (8)                              |                      |   |                                  |
| Cancellation of restricted stock  |  |        | (517)        | (5)      | 5                                |                      |   |                                  |
| Retirement of restricted stock to pay<br>taxes  |  |        | (32)         |          | (448)                            |                      |   | (448)                            |
| Amortization of deferred stock<br>compensation prior to adoption of<br>SFAS No. 123(R), net of cancellations<br>and retirements |  |        |              |          | 1,974                            |                      |   | 1,974                            |
|   |  |        |              |          | (2,777)                          |                      |   | (2,777)                          |

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|  |     |  |   |  |  |       |  |  |       |
|--|-----|--|---|--|--|-------|--|--|-------|
| Cumulative effect of accounting change         |     |  |   |  |  |       |  |  |       |
| Stock-based compensation under SFAS No. 123(R) |     |  |   |  |  |       |  |  |       |
|  |     |  |   |  |  | 8,608 |  |  | 8,608 |
| Other  | (3) |  | 3 |  |  | 42    |  |  | 42    |

|                             |       |    |    |         |    |       |    |           |    |         |    |           |    |           |
|-----------------------------|-------|----|----|---------|----|-------|----|-----------|----|---------|----|-----------|----|-----------|
| Balance, September 30, 2005 | 1,300 | \$ | 13 | 372,962 | \$ | 3,730 | \$ | 2,237,421 | \$ | 451,070 | \$ | (177,939) | \$ | 2,514,295 |
|-----------------------------|-------|----|----|---------|----|-------|----|-----------|----|---------|----|-----------|----|-----------|

See accompanying notes to consolidated financial statements

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

|   | <b>Nine Months Ended September 30,</b> |                |
|---|--|----------------|
|   | <b>2006</b>                            | <b>2005</b>    |
| <b>Cash flows from operating activities:</b>  |  |                |
| Net income  | \$ 452,204                             | \$ 301,052     |
| Adjustments to reconcile net income to net cash provided by operating activities:   |  |                |
| Cumulative effect of accounting change, net of tax  |  | (1,646)        |
| Provision for loan losses   | 33,014                                 | 37,946         |
| Depreciation and amortization (including discount amortization and accretion)   | 215,171                                | 265,686        |
| Gain on sales and impairment of investments   | (54,539)                               | (144,168)      |
| Minority interest in subsidiaries and equity in income of investments and venture funds                                   | (1,701)                                | (7,200)        |
| Non-cash facility restructuring costs and other exit activities   | 11,489                                 | 3,764          |
| Stock-based compensation  | 27,618                                 | 10,582         |
| Tax benefit from tax deductions in excess of compensation expense   | (23,121)                               | (19,126)       |
| Other   | 13,352                                 | (9,349)        |
| Net effect of changes in assets and liabilities:  |  |                |
| Decrease in cash and investments required to be segregated under Federal or other regulations                             | 352,724                                | 527,443        |
| Increase in brokerage receivables   | (30,236)                               | (733,025)      |
| Increase in brokerage payables  | 19,186                                 | 133,776        |
| Proceeds from sales, repayments and maturities of loans held-for-sale   | 1,095,150                              | 5,610,773      |
| Purchases of loans held-for-sale  | (1,409,547)                            | (3,096,313)    |
| Proceeds from sales, repayments and maturities of trading securities  | 1,463,808                              | 3,134,296      |
| Purchases of trading securities   | (1,480,586)                            | (5,265,037)    |
| Other assets  | (229,085)                              | 37,672         |
| Accounts payable, accrued and other liabilities   | 197,555                                | (118,572)      |
| Facility restructuring liabilities  | (13,568)                               | (7,301)        |
| Net cash provided by operating activities   | 638,888                                | 661,253        |
| <b>Cash flows from investing activities:</b>  |  |                |
| Purchases of available-for-sale mortgage-backed and investment securities   | (8,166,130)                            | (12,368,805)   |
| Proceeds from sales, maturities of and principal payments on available-for-sale mortgage-backed and investment securities | 5,389,695                              | 13,520,532     |
| Net increase in loans receivable  | (3,694,479)                            | (6,007,625)    |
| Purchases of property and equipment   | (68,241)                               | (58,302)       |
| Cash used in business acquisitions, net <sup>(1)</sup>  | (15,135)                               | (5,737)        |
| Net cash flow from derivatives hedging assets   | (50,257)                               | (26,414)       |
| Other   | 20,459                                 | 20,778         |
| Net cash used in investing activities   | \$ (6,584,088)                         | \$ (4,925,573) |

<sup>(1)</sup> In 2006, cash used in business acquisitions was related to the BrownCo purchase price true-up based on the final acquisition balance sheet and acquisition of Retirement Advisors of America ( RAA ).

See accompanying notes to consolidated financial statements



**Table of Contents****E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)****(In thousands)****(Unaudited)**

|  | <b>Nine Months Ended September 30,</b> |                  |
|--|--|------------------|
|  | <b>2006</b>                            | <b>2005</b>      |
| <b>Cash flows from financing activities:</b>                                     |  |                  |
| Net increase in deposits   | \$ 6,367,905                           | \$ 2,267,717     |
| Advances from other long-term borrowings   | 2,449,414                              | 17,018,000       |
| Payments on advances from other long-term borrowings                             | (2,561,616)                            | (14,187,000)     |
| Net decrease in securities sold under agreements to repurchase                   | (116,877)                              | (831,856)        |
| Net increase (decrease) in other borrowed funds                                  | 66,492                                 | (14,941)         |
| Payments for redemption of 6% convertible notes                                  | (1,754)                                |                  |
| Proceeds from issuance of senior notes   |  | 447,452          |
| Proceeds from issuance of common stock from employee stock transactions          | 43,825                                 | 48,299           |
| Tax benefit from tax deductions in excess of compensation expense recognition    | 23,121                                 | 19,126           |
| Repurchases of common stock  | (82,774)                               | (58,215)         |
| Proceeds from issuance of subordinated debentures and trust preferred securities | 44,900                                 | 20,000           |
| Net cash flow from derivatives hedging liabilities                               | 68,014                                 | (14,148)         |
| Other  |  | (458)            |
| <b>Net cash provided by financing activities</b>                                 | <b>6,300,650</b>                       | <b>4,713,976</b> |
| <br>Increase in cash and equivalents   | <br>355,450                            | <br>449,656      |
| Cash and equivalents, beginning of period  | 844,188                                | 939,906          |
| <br>Cash and equivalents, end of period  | <br>\$ 1,199,638                       | <br>\$ 1,389,562 |
| <b>Supplemental disclosures:</b>   |  |                  |
| Cash paid for interest   | \$ 1,012,858                           | \$ 547,932       |
| Cash paid for income taxes   | \$ 112,778                             | \$ 88,023        |
| Non-cash investing and financing activities:                                     |  |                  |
| Transfers from loans to other real estate owned and repossessed assets           | \$ 39,509                              | \$ 36,788        |
| Reclassification of loans held-for-sale to loans held-for-investment             | \$ 124,817                             | \$ 126,887       |
| Issuance of common stock to retire debentures                                    | \$ 183,411                             | \$               |

See accompanying notes to consolidated financial statements

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**E\*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

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

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

**Basis of Presentation** These consolidated financial statements have been prepared in accordance with GAAP for interim financial information and Regulation S-X, Article 10 under the Securities Exchange Act of 1934. They are unaudited and do not include all disclosures found in our annual financial statements. Management believes it has made all necessary adjustments so that the financial statements are presented fairly. The results of operations for the three and nine months ended September 30, 2006 may not be indicative of future results. Certain prior period items in these consolidated financial statements have been reclassified to conform to the current period presentation. As discussed in Note 2, the operations of certain businesses have been accounted for as discontinued operations in accordance with the Statement of Financial Accounting Standards ( SFAS ) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Accordingly, results of operations from prior periods have been reclassified to discontinued operations. Unless noted, discussions herein pertain to the Company's continuing operations.

These consolidated financial statements should be read in conjunction with the consolidated financial statements of E\*TRADE Financial Corporation included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

**New Income Statement Reporting Format** During the nine month period ended September 30, 2006, we modified the format of our consolidated income statement to a format that we believe provides a clearer picture of our financial performance and is more consistent with the common presentation found in the financial services industry. We re-ordered the revenue section by placing net operating interest income, which we previously referred to as net interest income, first, and non-interest income second. In addition, we updated our expense presentation to eliminate the remaining bank/brokerage lines. In conjunction with this change, we created a new expense category, Clearing and servicing. This new category includes trade clearing-related expense, previously included in Commissions, clearance and floor brokerage and most expenses previously included in Servicing and other banking expenses. We also consolidated Fair value adjustments of financial derivatives into the Other expense category. Information related to fair value adjustments of financial derivatives is detailed in Note 8 to the consolidated financial statements.

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

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

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**New Balance Sheet Reporting Format** We re-aligned our balance sheet to consolidate several categories and to change the name of Other borrowings by Bank subsidiary to Other borrowings. Other borrowings include non-Bank subsidiary term notes, previously classified in Accounts payable, accrued and other liabilities. Categories consolidated include the following:

Investment in Federal Home Loan Bank stock was added to Available-for-sale mortgage-backed and investment securities ;

Derivative assets and Accrued interest receivable were added to Other assets ; and

Derivative liabilities was added to Accounts payable, accrued and other liabilities.

These categories were consolidated with other similar items in our balance sheet presentation. The notes to our consolidated financial statements include detailed derivative asset and liability information.

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

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

### *SFAS No. 155 Accounting for Certain Hybrid Financial Instruments*

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, an amendment of SFAS 133 and 140. This statement establishes, among other things, the accounting for certain derivatives embedded in other financial instruments, which are referred to as hybrid financial instruments. The statement simplifies accounting for certain hybrid financial instruments by permitting fair value re-measurement for any hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation. The statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006, or January 1, 2007 for the Company. The Company has not determined the impact of implementation but does not anticipate that this statement will have a material impact to the Company's financial condition, results of operations or cash flows.

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

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, an amendment of SFAS 140. This statement establishes, among other things, the accounting for all separately recognized servicing assets and liabilities. This statement amends SFAS No. 140 to require that all separately recognized servicing assets and liabilities be initially measured at fair value. An entity that uses derivative instruments to mitigate the risk inherent in servicing assets and liabilities may carry servicing assets and liabilities at fair value. The statement is effective at the beginning of an entity's first fiscal year that begins after September 15, 2006, or January 1, 2007 for the Company. The Company has not determined the impact of implementation but does not anticipate that this statement will have a material impact to the Company's financial condition, results of operations or cash flows.

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

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement establishes, among other things, a framework for measuring fair value and expands disclosure requirements as they relate to

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fair value measurements. The statement is effective at the beginning of an entity's first fiscal year that begins after November 15, 2007 or January 1, 2008 for the Company. The Company is currently evaluating the impact this guidance will have on its financial condition, results of operations or cash flows.

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

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109*. The interpretation clarifies, among other things, the accounting for uncertainty in income taxes recognized in an enterprise's financial statements by mandating a consistent approach to recognizing income tax benefits, and applies to all tax positions accounted for in accordance with SFAS 109, *Accounting for Income Taxes*. Specifically, the interpretation requires a two prong approach be followed in connection with recognizing any financial statement benefit relating to income taxes. First, a tax position must be more likely than not of ultimately being sustained if challenged by taxing authorities before any tax benefit can be recognized. This threshold must be met assuming that the tax authorities will examine the tax position. Second, the amount of tax benefit related to any such tax position recorded in the financial statements is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement with the taxing authorities.

The interpretation also contains guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation will be effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying the provisions of the interpretation will be reported as an adjustment to the opening balance of retained earnings as of January 1, 2007. The Company is in the process of determining the amount of the cumulative effect this interpretation will require or whether it will have a material effect on our financial condition.

**NOTE 2 DISCONTINUED OPERATIONS***E\*TRADE Professional Securities, LLC and E\*TRADE Professional Trading, LLC*

In May 2005, the Company closed E\*TRADE Professional Securities, LLC, a unit that conducted proprietary trading operations. In December 2005, the Company decided to sell its professional agency business, E\*TRADE Professional Trading, LLC. The Company executed a sale agreement on February 17, 2006 and settled this transaction on July 3, 2006. The Company recorded approximately \$2.8 million in gain, net of tax, on the sale of this business during the three months ended September 30, 2006.

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

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2006                                | 2005       | 2006                               | 2005       |
| Net revenue                                   | \$                                  | \$ 2,982   | \$ 5,526                           | \$ 18,766  |
| Loss from discontinued operations             | \$                                  | \$ (1,131) | \$ (1,181)                         | \$ (9,596) |
| Income tax benefit                            |                                     | (447)      | (460)                              | (3,786)    |
| Loss from discontinued operations, net of tax | \$                                  | \$ (684)   | \$ (721)                           | \$ (5,810) |

*E\*TRADE Consumer Finance Corporation*

In October 2005, the Company completed the sale of the servicing and origination businesses of E\*TRADE Consumer Finance Corporation. The exit of the servicing business did not qualify as a discontinued operation; however, the origination business did qualify as a discontinued operation. In September 2006, the Company finalized certain post sale contingencies with the purchaser which resulted in a \$0.2 million gain, net of tax.

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The following table summarizes the results of discontinued operations for the origination business (dollars in thousands):

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2006</b>               | <b>2005</b> | <b>2006</b>              | <b>2005</b> |
| Net loss                                      | \$                        | \$ (552)    | \$                       | \$ (7,285)  |
| Loss from discontinued operations             | \$                        | \$ (4,502)  | \$                       | \$ (21,201) |
| Income tax benefit                            |                           | (1,722)     |                          | (8,110)     |
| Loss from discontinued operations, net of tax | \$                        | \$ (2,780)  | \$                       | \$ (13,091) |

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

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

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2006</b>               | <b>2005</b> | <b>2006</b>              | <b>2005</b> |
| 2003 Restructuring Plan                                | \$ (48)                   | \$ (416)    | \$ (368)                 | \$ (419)    |
| 2001 Restructuring Plan                                | 26                        | (69)        | (321)                    | 323         |
| Other exit activities                                  | 16,706                    | 16          | 20,004                   | 591         |
| Total facility restructuring and other exit activities | \$ 16,684                 | \$ (469)    | \$ 19,315                | \$ 495      |

**2003 Restructuring Plan**

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

|  | <b>Facility</b>      |              |              |
|--|----------------------|--------------|--------------|
|  | <b>Consolidation</b> | <b>Other</b> | <b>Total</b> |
| Original 2003 Restructuring Reserve:                           |                      |              |              |
| Facility restructuring and other exit activities recorded      | \$ 59,510            | \$ 57,319    | \$ 116,829   |
| Cash payments  | (21,539)             | (18,949)     | (40,488)     |
| Non-cash charges   | (19,254)             | (38,370)     | (57,624)     |
| Restructuring liabilities at December 31, 2005                 | 18,717               |              | 18,717       |
| Activity for the nine months ended September 30, 2006:         |                      |              |              |
| Adjustment and additional charges                              | (368)                |              | (368)        |
| Cash payments  | (3,662)              |              | (3,662)      |
| Total facility restructuring liabilities at September 30, 2006 | \$ 14,687            | \$           | \$ 14,687    |



**Table of Contents****2001 Restructuring Plan**

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

|  | <b>Facility</b>      |                        |              |              |
|--|----------------------|------------------------|--------------|--------------|
|  | <b>Consolidation</b> | <b>Asset Write-Off</b> | <b>Other</b> | <b>Total</b> |
| Original 2001 Restructuring Reserve:   |                      |                        |              |              |
| Facility restructuring and other exit activities recorded                                | \$ 150,416           | \$ 54,384              | \$ 26,036    | \$ 230,836   |
| Cash payments  | (101,698)            | (507)                  | (19,434)     | (121,639)    |
| Non-cash charges   | (41,263)             | (53,877)               | (5,810)      | (100,950)    |
| Restructuring liabilities at December 31, 2005   | 7,455                |                        | 792          | 8,247        |
| Activity for the nine months ended September 30, 2006:                                   |                      |                        |              |              |
| Adjustments and additional charges   | (685)                |                        | 364          | (321)        |
| Cash payments  | (1,920)              |                        | (1,074)      | (2,994)      |
| Total facility restructuring and other exit activities liabilities at September 30, 2006 | \$ 4,850             | \$                     | \$ 82        | \$ 4,932     |

**Other Exit Activities**

Toward the end of the second quarter of 2006, the Company decided to relocate certain functions out of the state of California. As a result, the Company incurred costs of \$16.7 million and \$19.4 million for the three and nine months ended September 30, 2006, respectively, related to severance costs for employees impacted by the facility closings and costs for exiting those facilities. Additionally, for the three and nine months ended September 30, 2006, other exit activities included severance costs associated with the outsourcing of certain clearing operations and costs related to the relocation of certain accounting functions. The total charge for this exit activity is expected to be between \$30.0 million and \$35.0 million, all of which will be recorded in the retail segment.

For the three and nine months ended September 30, 2005, other exit activities were primarily related to the liquidation of the E\*TRADE Money Market Funds, partially offset by the revision of previous estimates of various exit activities. The liquidation costs primarily related to customer notification, severance and reimbursement of losses taken on sales of securities.

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

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

|   | <b>Three Months Ended</b> |                      | <b>Nine Months Ended</b> |                      |
|---|---------------------------|----------------------|--------------------------|----------------------|
|   | <b>September 30,</b>      | <b>September 30,</b> | <b>September 30,</b>     | <b>September 30,</b> |
|   | <b>2006</b>               | <b>2005</b>          | <b>2006</b>              | <b>2005</b>          |
| Operating interest income:                |                           |                      |                          |                      |
| Loans, net                                | \$ 364,744                | \$ 232,004           | \$ 949,513               | \$ 569,191           |
| Mortgage-backed and investment securities | 205,838                   | 120,827              | 555,693                  | 389,612              |
| Margin receivables                        | 123,855                   | 37,844               | 352,149                  | 101,110              |
| Other                                     | 36,992                    | 33,439               | 128,741                  | 88,471               |
| Total operating interest income           | 731,429                   | 424,114              | 1,986,096                | 1,148,384            |
| Operating interest expense:               |                           |                      |                          |                      |

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|                                  |            |            |              |            |
|----------------------------------|------------|------------|--------------|------------|
| Deposits                         | 148,488    | 62,525     | 364,864      | 158,388    |
| Other borrowings                 | 227,805    | 144,576    | 596,705      | 377,144    |
| Total operating interest expense | 376,293    | 207,101    | 961,569      | 535,532    |
| Net operating interest income    | \$ 355,136 | \$ 217,013 | \$ 1,024,527 | \$ 612,852 |

**Table of Contents****Note 5 AVAILABLE-FOR-SALE MORTGAGE-BACKED AND INVESTMENT SECURITIES**

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

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Values |
|--|-------------------|------------------------------|-------------------------------|--------------------------|
| <b>September 30, 2006:</b>                               |                   |                              |                               |                          |
| Mortgage-backed securities:                              |                   |                              |                               |                          |
| Backed by U.S. Government sponsored and Federal agencies | \$ 11,211,817     | \$ 3,967                     | \$ (250,492)                  | \$ 10,965,292            |
| Collateralized mortgage obligations and other            | 1,052,763         | 371                          | (20,593)                      | 1,032,541                |
| Total mortgage-backed securities                         | 12,264,580        | 4,338                        | (271,085)                     | 11,997,833               |
| Investment securities:                                   |                   |                              |                               |                          |
| Debt securities:   |                   |                              |                               |                          |
| Asset-backed securities                                  | 2,031,163         | 6,798                        | (13,026)                      | 2,024,935                |
| Municipal bonds  | 481,984           | 9,121                        | (811)                         | 490,294                  |
| Corporate bonds  | 116,668           |                              | (1,781)                       | 114,887                  |
| Other debt securities                                    | 78,619            |                              | (5,929)                       | 72,690                   |
| Total debt securities                                    | 2,708,434         | 15,919                       | (21,547)                      | 2,702,806                |
| Publicly traded equity securities:                       |                   |                              |                               |                          |
| Preferred stock  | 399,043           | 1,713                        | (2,368)                       | 398,388                  |
| Corporate investments                                    | 18,432            | 19,245                       | (1,290)                       | 36,387                   |
| FHLB stock   | 193,750           |                              |                               | 193,750                  |
| Retained interests from securitizations                  | 3,413             | 386                          |                               | 3,799                    |
| Total investment securities                              | 3,323,072         | 37,263                       | (25,205)                      | 3,335,130                |
| Total available-for-sale securities                      | \$ 15,587,652     | \$ 41,601                    | \$ (296,290)                  | \$ 15,332,963            |
| <b>December 31, 2005:</b>                                |                   |                              |                               |                          |
| Mortgage-backed securities:                              |                   |                              |                               |                          |
| Backed by U.S. Government sponsored and Federal agencies | \$ 9,687,666      | \$                           | \$ (260,145)                  | \$ 9,427,521             |
| Collateralized mortgage obligations and other            | 1,014,582         | 315                          | (19,006)                      | 995,891                  |
| Total mortgage-backed securities                         | 10,702,248        | 315                          | (279,151)                     | 10,423,412               |
| Investment securities:                                   |                   |                              |                               |                          |
| Debt securities:   |                   |                              |                               |                          |
| Asset-backed securities                                  | 1,376,315         | 1,811                        | (12,372)                      | 1,365,754                |
| Municipal bonds  | 168,682           | 1,884                        | (882)                         | 169,684                  |
| Corporate bonds  | 74,931            |                              | (2,171)                       | 72,760                   |
| Other debt securities                                    | 78,989            |                              | (5,504)                       | 73,485                   |
| Total debt securities                                    | 1,698,917         | 3,695                        | (20,929)                      | 1,681,683                |
| Publicly traded equity securities:                       |                   |                              |                               |                          |
| Preferred stock  | 290,240           | 267                          | (2,142)                       | 288,365                  |
| Corporate investments                                    | 53,152            | 94,412                       | (164)                         | 147,400                  |
| FHLB stock   | 198,700           |                              |                               | 198,700                  |

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|   |               |            |              |               |
|---|---------------|------------|--------------|---------------|
| Retained interests from securitizations | 22,444        | 1,434      |              | 23,878        |
| Total investment securities             | 2,263,453     | 99,808     | (23,235)     | 2,340,026     |
| Total available-for-sale securities     | \$ 12,965,701 | \$ 100,123 | \$ (302,386) | \$ 12,763,438 |

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

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

|  | Less than 12 Months |                      | 12 Months or More |                      | Total          |                      |
|--|---------------------|----------------------|-------------------|----------------------|----------------|----------------------|
|  | Fair<br>Values      | Unrealized<br>Losses | Fair<br>Values    | Unrealized<br>Losses | Fair<br>Values | Unrealized<br>Losses |
| <b>September 30, 2006:</b>                               |                     |                      |                   |                      |                |                      |
| Mortgage-backed securities:                              |                     |                      |                   |                      |                |                      |
| Backed by U.S. Government sponsored and Federal agencies | \$ 3,390,836        | \$ (57,017)          | \$ 6,621,428      | \$ (193,475)         | \$ 10,012,264  | \$ (250,492)         |
| Collateralized mortgage obligations and other            | 319,115             | (3,310)              | 596,054           | (17,283)             | 915,169        | (20,593)             |
| Debt securities:   |                     |                      |                   |                      |                |                      |
| Asset-backed securities                                  | 556,978             | (3,866)              | 520,071           | (9,160)              | 1,077,049      | (13,026)             |
| Municipal bonds  | 60,417              | (399)                | 23,090            | (412)                | 83,507         | (811)                |
| Corporate bonds  |                     |                      | 72,678            | (1,781)              | 72,678         | (1,781)              |
| Other debt securities                                    |                     |                      | 72,690            | (5,929)              | 72,690         | (5,929)              |
| Publicly traded equity securities:                       |                     |                      |                   |                      |                |                      |
| Preferred stock  | 12,511              | (498)                | 25,713            | (1,870)              | 38,224         | (2,368)              |
| Corporate investments                                    | 3,797               | (1,290)              |                   |                      | 3,797          | (1,290)              |
| Total temporarily impaired securities                    | \$ 4,343,654        | \$ (66,380)          | \$ 7,931,724      | \$ (229,910)         | \$ 12,275,378  | \$ (296,290)         |
| <b>December 31, 2005:</b>                                |                     |                      |                   |                      |                |                      |
| Mortgage-backed securities:                              |                     |                      |                   |                      |                |                      |
| Backed by U.S. Government sponsored and Federal agencies | \$ 5,914,808        | \$ (142,245)         | \$ 3,512,713      | \$ (117,900)         | \$ 9,427,521   | \$ (260,145)         |
| Collateralized mortgage obligations and other            | 351,565             | (5,177)              | 546,291           | (13,829)             | 897,856        | (19,006)             |
| Debt securities:   |                     |                      |                   |                      |                |                      |
| Asset-backed securities                                  | 412,142             | (3,064)              | 411,595           | (9,308)              | 823,737        | (12,372)             |
| Municipal bonds  | 21,006              | (165)                | 22,775            | (717)                | 43,781         | (882)                |
| Corporate bonds  |                     |                      | 72,760            | (2,171)              | 72,760         | (2,171)              |
| Other debt securities                                    |                     |                      | 73,485            | (5,504)              | 73,485         | (5,504)              |
| Publicly traded equity securities:                       |                     |                      |                   |                      |                |                      |
| Preferred stock  | 86,292              | (1,171)              | 11,759            | (971)                | 98,051         | (2,142)              |
| Corporate investments                                    | 246                 | (164)                |                   |                      | 246            | (164)                |
| Total temporarily impaired securities                    | \$ 6,786,059        | \$ (151,986)         | \$ 4,651,378      | \$ (150,400)         | \$ 11,437,437  | \$ (302,386)         |

The Company does not believe that any individual loss as of September 30, 2006 represents an other-than-temporary impairment. The majority of the unrealized losses on mortgage- and asset-backed securities are attributable to changes in interest rates and are not reflective of deterioration in the credit quality of the issuer and/or securitization. Substantially all mortgage-backed securities backed by U.S. Government sponsored and Federal agencies are AAA rated and have unrealized losses due to changes in market interest rates. As market interest rates increase, the fair value of fixed-rate securities will decrease. During 2006, increasing market interest rates caused higher unrealized losses on our fixed-rate securities, including mortgage- and asset-backed securities. The Company has the intent and ability to hold these securities until the market value recovers or the securities mature. Municipal bonds, corporate bonds and other debt securities are evaluated by reviewing the credit-worthiness of the lender and general market conditions. Based on its evaluation, the Company recorded

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\$1.9 million and \$2.3 million of impairment for the three and nine months ended September 30, 2006, respectively. For the three and nine months ended September 30, 2005, the Company recorded \$7.4 million and \$38.3 million of impairment, respectively, for its asset- and mortgage-backed, interest-only and other securities.

The detailed components of the line items Gain on sales of loans and securities, net and Gain on sales and impairment of investments on the consolidated statement of income are shown below.

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

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

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2006                                | 2005      | 2006                               | 2005      |
| Gain on sales of originated loans          | \$ 3,213                            | \$ 14,811 | \$ 9,212                           | \$ 47,147 |
| Loss on sales of loans held-for-sale, net  | (235)                               | (543)     | (1,333)                            | (1,442)   |
| Gain on sales of securities, net           | 13,025                              | 7,582     | 30,859                             | 38,416    |
| Gain on sales of loans and securities, net | \$ 16,003                           | \$ 21,850 | \$ 38,738                          | \$ 84,121 |

### *Gain on Sales and Impairment of Investments*

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

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2006                                | 2005      | 2006                               | 2005      |
| Gain on sales of publicly traded equity securities               | \$ 26,489                           | \$ 22,560 | \$ 60,046                          | \$ 68,147 |
| Realized losses on sales of investments and impairments          |                                     | (40)      | (455)                              | (40)      |
| Gain (losses) on sales of other equity securities <sup>(1)</sup> | 502                                 | (492)     | 306                                | 65        |
| Gain on sales and impairment of investments                      | \$ 26,991                           | \$ 22,028 | \$ 59,897                          | \$ 68,172 |

<sup>(1)</sup> Includes realized gains on retained interests from securitizations.

**Table of Contents****NOTE 6 LOANS, NET**

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

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
| Loans held-for-sale  | \$ 208,633            | \$ 87,371            |
| Loans receivable, net:   |                       |                      |
| Real estate loans:   |                       |                      |
| One- to four-family  | 8,912,645             | 7,091,664            |
| Home equity lines of credit ( HELOC ), second mortgage and other | 10,446,593            | 8,106,820            |
| Total real estate loans  | 19,359,238            | 15,198,484           |
| Consumer and other loans:  |                       |                      |
| Recreational vehicle   | 2,400,979             | 2,692,055            |
| Marine   | 683,166               | 752,645              |
| Credit card  | 198,022               | 188,600              |
| Automobile   | 102,968               | 235,388              |
| Other  | 185,755               | 97,436               |
| Total consumer and other loans                                   | 3,570,890             | 3,966,124            |
| Total loans receivable   | 22,930,128            | 19,164,608           |
| Unamortized premiums, net  | 355,224               | 323,573              |
| Allowance for loan losses  | (69,908)              | (63,286)             |
| Total loans receivable, net                                      | 23,215,444            | 19,424,895           |
| Total loans, net   | \$ 23,424,077         | \$ 19,512,266        |

**NOTE 7 BROKERAGE RECEIVABLES, NET AND BROKERAGE PAYABLES**

Brokerage receivables, net and brokerage payables consist of the following (dollars in thousands):

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
| Receivables from customers and non-customers (less allowance for doubtful accounts of \$19,931 at September 30, 2006 and \$8,835 at December 31, 2005) | \$ 6,415,919          | \$ 5,678,923         |
| Receivables from brokers, dealers and clearing organizations:  |                       |                      |
| Deposits paid for securities borrowed  | 489,659               | 1,163,125            |
| Net settlement and deposits with clearing organizations  | 190,178               | 230,936              |
| Other  | 135,204               | 101,191              |
| Total brokerage receivables, net   | \$ 7,230,960          | \$ 7,174,175         |
| Payables to customers and non-customers  | \$ 6,187,177          | \$ 5,817,469         |
| Payables to brokers, dealers and clearing organizations:   |                       |                      |
| Deposits received for securities loaned  | 857,499               | 1,320,853            |
| Other  | 354,603               | 203,886              |

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|                          |              |              |
|--------------------------|--------------|--------------|
| Total brokerage payables | \$ 7,399,279 | \$ 7,342,208 |
|--------------------------|--------------|--------------|

Receivables from customers and non-customers are primarily brokerage receivables where customers use their securities as collateral (also known as margin receivables). Receivables from non-customers primarily represent credit extended to principal officers and directors of the Company to finance their purchase of securities on margin. Securities owned by customers and non-customers are held as collateral for amounts due on

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margin receivables, the value of which is not reflected in the consolidated balance sheet. In many cases, the Company is permitted to sell or re-pledge these securities held as collateral and use the securities to enter into securities lending transactions, to collateralize borrowings or for delivery to counterparties to cover customer short positions. At September 30, 2006, the fair value of securities that the Company received as collateral, where the Company is permitted to sell or re-pledge the securities, was approximately \$9.1 billion. Of this amount, \$1.8 billion had been pledged or sold at September 30, 2006 in connection with securities loans, bank borrowings and deposits with clearing organizations.

Receivables from and payables to brokers, dealers and clearing organizations resulted from the Company's brokerage activities. Payable to customers and non-customers represents free credit balances and other customer and non-customer funds pending completion of securities transactions. The Company pays interest on certain customer and non-customer credit balances.

**NOTE 8 ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES**

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

***Fair Value Hedges***

*Overview of Fair Value Hedges*

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on swaps, interest rate caps and interest rate floors to offset its exposure to changes in value of certain fixed-rate assets and liabilities. In calculating the effective portion of fair value hedges under SFAS No. 133, changes in the fair value of the derivatives are recognized currently in earnings. Accordingly, the net difference or hedge ineffectiveness, if any, is recognized currently in other expense excluding interest in the consolidated statement of income.

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

|  | Notional<br>Amount of<br>Derivatives | Fair Value of Derivatives |             |             | Weighted-Average |                 | Strike<br>Rate | Remaining<br>Life (Years) |
|--|--------------------------------------|---------------------------|-------------|-------------|------------------|-----------------|----------------|---------------------------|
|  |                                      | Asset                     | Liability   | Net         | Pay<br>Rate      | Receive<br>Rate |                |                           |
| <b>September 30, 2006:</b>                       |                                      |                           |             |             |                  |                 |                |                           |
| Pay-fixed interest rate swaps:                   |                                      |                           |             |             |                  |                 |                |                           |
| Mortgage-backed securities                       | \$ 3,971,000                         | \$ 17,579                 | \$ (29,457) | \$ (11,878) | 5.13%            | 5.40%           | N/A            | 4.63                      |
| RV loans   | 2,030,000                            |                           | (11,146)    | (11,146)    | 5.46%            | 5.33%           | N/A            | 1.88                      |
| Home equity loans                                | 490,000                              |                           | (3,498)     | (3,498)     | 5.40%            | 5.33%           | N/A            | 2.41                      |
| Investment securities                            | 335,162                              | 1,252                     | (3,146)     | (1,894)     | 5.07%            | 5.42%           | N/A            | 6.95                      |
| Asset backed securities                          | 223,000                              | 221                       | (5,109)     | (4,888)     | 5.39%            | 5.41%           | N/A            | 6.68                      |
| Receive-fixed interest rate swaps:               |                                      |                           |             |             |                  |                 |                |                           |
| Senior notes                                     | 300,000                              | 528                       | (1,429)     | (901)       | 7.80%            | 7.88%           | N/A            | 9.18                      |
| Brokered certificates of deposit                 | 128,052                              |                           | (4,467)     | (4,467)     | 5.37%            | 5.21%           | N/A            | 11.69                     |
| FHLB advances                                    | 100,000                              |                           | (3,690)     | (3,690)     | 5.33%            | 3.64%           | N/A            | 3.04                      |
| Purchased interest rate forward-starting swaps:  |                                      |                           |             |             |                  |                 |                |                           |
| Mortgage-backed securities                       | 790,000                              | 166                       | (11,008)    | (10,842)    | 5.42%            | N/A             | N/A            | 5.38                      |
| Asset-backed securities                          | 45,000                               | 69                        |             | 69          | 5.13%            | N/A             | N/A            | 8.68                      |
| Purchased interest rate options <sup>(1)</sup> : |                                      |                           |             |             |                  |                 |                |                           |
| Caps   | 7,020,000                            | 47,998                    |             | 47,998      | N/A              | N/A             | 5.36%          | 2.41                      |
| Swaptions <sup>(2)</sup>                         | 4,190,000                            | 62,627                    |             | 62,627      | N/A              | N/A             | 5.51%          | 10.34                     |
| Floors   | 1,200,000                            | 22,331                    |             | 22,331      | N/A              | N/A             | 4.74%          | 5.06                      |
| Total fair value hedges                          | \$ 20,822,214                        | \$ 152,771                | \$ (72,950) | \$ 79,821   | 5.36%            | 5.45%           | 5.35%          | 4.93                      |
| <b>December 31, 2005:</b>                        |                                      |                           |             |             |                  |                 |                |                           |
| Pay-fixed interest rate swaps:                   |                                      |                           |             |             |                  |                 |                |                           |
| Mortgage-backed securities                       | \$ 961,000                           | \$ 12,485                 | \$ (598)    | \$ 11,887   | 4.50%            | 4.35%           | N/A            | 4.88                      |
| Investment securities                            | 119,485                              | 1,315                     | (1,750)     | (435)       | 4.62%            | 4.18%           | N/A            | 7.70                      |
| Receive-fixed interest rate swaps:               |                                      |                           |             |             |                  |                 |                |                           |
| Brokered certificates of deposit                 | 132,313                              |                           | (3,740)     | (3,740)     | 4.33%            | 5.22%           | N/A            | 12.50                     |
| FHLB advances                                    | 100,000                              |                           | (3,894)     | (3,894)     | 4.37%            | 3.64%           | N/A            | 3.79                      |
| Purchased interest rate forward-starting swaps:  |                                      |                           |             |             |                  |                 |                |                           |
| Mortgage-backed securities                       | 70,000                               |                           | (470)       | (470)       | 5.03%            | N/A             | N/A            | 10.01                     |
| Purchased interest rate options <sup>(1)</sup> : |                                      |                           |             |             |                  |                 |                |                           |
| Caps   | 770,000                              | 21,324                    |             | 21,324      | N/A              | N/A             | 4.89%          | 4.82                      |
| Swaptions <sup>(2)</sup>                         | 2,241,000                            | 36,982                    |             | 36,982      | N/A              | N/A             | 4.93%          | 8.47                      |
| Floors   | 1,325,000                            | 3,952                     |             | 3,952       | N/A              | N/A             | 3.82%          | 3.71                      |
| Total fair value hedges                          | \$ 5,718,798                         | \$ 76,058                 | \$ (10,452) | \$ 65,606   | 4.51%            | 4.37%           | 4.59%          | 6.29                      |

<sup>(1)</sup> Purchased interest rate options were used to hedge mortgage-backed securities.

<sup>(2)</sup> Swaptions are options to enter swaps starting on a given day.

**De-designated Fair Value Hedges**

During the three and nine months ended September 30, 2006 and 2005, certain fair value hedges were de-designated; therefore, hedge accounting was discontinued during those periods. The net gain or loss on the underlying transactions being hedged is amortized to operating interest expense or operating interest income over the original forecasted period at the time of de-designation. Changes in the fair value of these derivative instruments after de-designation of fair value hedge accounting were recorded in the line item Gain on sales of loans and securities,

net in the consolidated statement of income.

***Cash Flow Hedges***

*Overview of Cash Flow Hedges*

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on caps and floors to hedge the variability of future cash flows associated with existing variable-rate liabilities and

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

Changes in the fair value of derivatives that hedge cash flows associated with repurchase agreements, FHLB advances and HELOC are reported in accumulated other comprehensive income as unrealized gains or losses. The amounts in accumulated other comprehensive income are then included in operating interest expense or operating interest income as a yield adjustment during the same periods in which the related interest on the fundings or investment securities affect earnings. During the upcoming twelve months, the Company expects to include a pre-tax amount of approximately \$22.1 million of net unrealized gains that are currently reflected in accumulated other comprehensive income in operating interest expense as a yield adjustment in the same periods in which the related items affect earnings.

The Company also recognizes cash flow hedge ineffectiveness. The amount of ineffectiveness recorded in earnings is equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of a hypothetical derivative which is created to match the exact terms of the underlying debt being hedged. The Company recognized this cash flow ineffectiveness in the Other line item within Expense excluding interest in the consolidated statement of income. Cash flow ineffectiveness is re-measured on a quarterly basis.

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

|  | Notional      | Fair Value of Derivatives |             |             | Weighted-Average |              |             |                        |
|--|---------------|---------------------------|-------------|-------------|------------------|--------------|-------------|------------------------|
|  | Amount of     |                           |             |             | Pay              |              |             |                        |
|  | Derivatives   | Asset                     | Liability   | Net         | Rate             | Receive Rate | Strike Rate | Remaining Life (Years) |
| <b>September 30, 2006:</b>                       |               |                           |             |             |                  |              |             |                        |
| Pay-fixed interest rate swaps:                   |               |                           |             |             |                  |              |             |                        |
| Repurchase agreements                            | \$ 2,790,000  | \$ 7,191                  | \$ (19,094) | \$ (11,903) | 5.34%            | 5.39%        | N/A         | 6.11                   |
| FHLB advances                                    | 530,000       | 2,366                     | (8,693)     | (6,327)     | 5.32%            | 5.44%        | N/A         | 9.41                   |
| Purchased interest rate forward-starting swaps:  |               |                           |             |             |                  |              |             |                        |
| Repurchase agreements                            | 670,000       |                           | (9,302)     | (9,302)     | 5.50%            | N/A          | N/A         | 7.24                   |
| Purchased interest rate options <sup>(1)</sup> : |               |                           |             |             |                  |              |             |                        |
| Caps   | 4,690,000     | 70,738                    |             | 70,738      | N/A              | N/A          | 5.05%       | 3.61                   |
| Floors   | 2,900,000     | 2,434                     |             | 2,434       | N/A              | N/A          | 5.33%       | 1.91                   |
| Total cash flow hedges                           | \$ 11,580,000 | \$ 82,729                 | \$ (37,089) | \$ 45,640   | 5.37%            | 5.40%        | 5.16%       | 4.26                   |
| <b>December 31, 2005:</b>                        |               |                           |             |             |                  |              |             |                        |
| Pay-fixed interest rate swaps:                   |               |                           |             |             |                  |              |             |                        |
| Repurchase agreements                            | \$ 1,100,000  | \$ 6,959                  | \$ (2,223)  | \$ 4,736    | 4.87%            | 4.38%        | N/A         | 9.15                   |
| Purchased interest rate forward-starting swaps:  |               |                           |             |             |                  |              |             |                        |
| Repurchase agreements                            | 2,675,000     | 1,219                     | (19,872)    | (18,653)    | 5.04%            | N/A          | N/A         | 9.50                   |
| FHLB advances                                    | 750,000       |                           | (4,040)     | (4,040)     | 5.02%            | N/A          | N/A         | 9.46                   |
| Purchased interest rate options <sup>(1)</sup> : |               |                           |             |             |                  |              |             |                        |
| Caps   | 2,925,000     | 64,301                    |             | 64,301      | N/A              | N/A          | 4.76%       | 4.59                   |
| Floors   | 1,900,000     | 2,527                     |             | 2,527       | N/A              | N/A          | 5.50%       | 3.54                   |
| Total cash flow hedges                           | \$ 9,350,000  | \$ 75,006                 | \$ (26,135) | \$ 48,871   | 5.00%            | 4.38%        | 5.05%       | 6.71                   |

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



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

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

|  | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |              |
|--|-------------------------------------|--------------|------------------------------------|--------------|
|  | 2006                                | 2005         | 2006                               | 2005         |
| Impact on accumulated other comprehensive income (net of taxes): |                                     |              |                                    |              |
| Beginning balance  | \$ 84,992                           | \$ (190,780) | \$ (70,831)                        | \$ (118,018) |
| Gains (losses) on cash flow hedges related to derivatives, net   | (107,665)                           | 83,027       | 43,078                             | (15,384)     |
| Reclassifications into earnings, net                             | 827                                 | 8,622        | 5,907                              | 34,271       |
| Ending balance   | \$ (21,846)                         | \$ (99,131)  | \$ (21,846)                        | \$ (99,131)  |

Derivatives terminated during the period:

|   |              |              |              |               |
|---|--------------|--------------|--------------|---------------|
| Notional  | \$ 1,265,000 | \$ 5,025,000 | \$ 9,375,000 | \$ 12,670,000 |
| Fair value of net gains (losses) recognized in accumulated other comprehensive income   | \$ (20,649)  | \$ 30,320    | \$ 93,245    | \$ (44,845)   |
| Amortization of terminated interest rate swaps and options included in operating interest expense and operating interest income | \$ (1,197)   | \$ (14,027)  | \$ (8,887)   | \$ (57,446)   |

The gains (losses) accumulated in other comprehensive income on the derivative instruments terminated shown in the preceding table will be included in operating interest expense and operating interest income over the periods the hedged forecasted issuance of liabilities will affect earnings, ranging from 16 days to almost 15 years.

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

|   | Nine Months Ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2006                               | 2005        |
| Accumulated other comprehensive income balance (net of taxes) related to: |                                    |             |
| Open cash flow hedges   | \$ (51,598)                        | \$ (31,415) |
| Discontinued cash flow hedges   | 29,752                             | (67,716)    |
| Total cash flow hedges  | \$ (21,846)                        | \$ (99,131) |

**Hedge Ineffectiveness**

In accordance with SFAS No. 133, the Company recognizes hedge ineffectiveness on both fair value and cash flow hedge relationships. These amounts are reflected in the Other line item within Expense excluding operating interest in the consolidated statement of income. The following table summarizes income (expense) recognized by the Company as fair value and cash flow hedge ineffectiveness (dollars in thousands):

|                   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|-------------------|-------------------------------------|------------|------------------------------------|------------|
|                   | 2006                                | 2005       | 2006                               | 2005       |
| Fair value hedges | \$ (1,652)                          | \$ (1,240) | \$ 2,029                           | \$ (3,861) |

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|                             |            |            |          |            |
|-----------------------------|------------|------------|----------|------------|
| Cash flow hedges            | 190        | (29)       | (163)    | (44)       |
| Total hedge ineffectiveness | \$ (1,462) | \$ (1,269) | \$ 1,866 | \$ (3,905) |

**Table of Contents*****Mortgage Banking Activities***

The Company enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding. These commitments are referred to as Interest Rate Lock Commitments ( IRLCs ). IRLCs on loans that the Company intends to sell are considered to be derivatives and are, therefore, recorded at fair value with changes in fair value recorded in earnings. For purposes of determining fair value, the Company performs a net present value analysis of the anticipated cash flows associated with these IRLCs. The net present value analysis performed excludes the market value associated with the anticipated sale of servicing rights related to each loan commitment. The fair value of these IRLCs was a \$0.5 million and \$1.6 million asset at September 30, 2006 and December 31, 2005, respectively.

The Company also designates fair value relationships of closed loans held-for-sale against a combination of mortgage forwards and short treasury positions. Short treasury relationships are economic hedges, rather than fair value or cash flow hedges. Short treasury positions are marked-to-market, but do not receive hedge accounting treatment under SFAS No. 133. The mark-to-market of the mortgage forwards is included in the net change of the IRLCs and the related hedging instruments. The fair value of the mark-to-market on closed loans was a \$2.0 million and \$0.7 million asset at September 30, 2006 and December 31, 2005, respectively.

IRLCs, as well as closed loans held-for-sale, expose the Company to interest rate risk. The Company manages this risk by selling mortgages or mortgage-backed securities on a forward basis referred to as forward sale agreements. Changes in the fair value of these derivatives are included as gain on sales of loans and securities, net in the consolidated statement of income. The net change in IRLCs, closed loans, mortgage forwards and the short treasury positions generated net gains of \$1.7 million and \$0.8 million for the three and nine months ended September 30, 2006, respectively. The net change in IRLCs, closed loans, mortgage forwards and the short treasury positions generated net gains of \$0.1 million and \$0.6 million for the three and nine months ended September 30, 2005, respectively.

**NOTE 9 EQUITY METHOD INVESTMENTS**

Equity method investments which are reported as part of the line item Other Assets on the consolidated balance sheet consist of the following (dollars in thousands):

|                                   | September 30,<br>2006 | December 31,<br>2005 |
|-----------------------------------|-----------------------|----------------------|
| Investsmart <sup>(1)(2)</sup>     | \$ 35,008             | \$                   |
| Arrowpath Fund II, L.P.           | 18,929                | 16,806               |
| International Securities Exchange | 4,000                 |                      |
| KAP Group, L.L.C.                 | 3,810                 | 4,365                |
| Softbank Capital Partners Inc.    | 3,728                 | 4,700                |
| Other                             | 3,136                 | 3,460                |
| Total equity method investments   | \$ 68,611             | \$ 29,331            |

(1) Investsmart was previously accounted for in accordance SFAS 115 and reported as part of Available-for-sale mortgage-backed and investment securities at December 31, 2005.

(2) Investsmart is an India-based financial services organization providing individuals and corporations with customized financial management solutions. During the third quarter, the Company increased its ownership stake in Investsmart to 28% and determined that it exercised significant influence over Investsmart. This resulted in a transition from an investment accounted for as available-for-sale in accordance with SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, to an investment accounted for under equity method accounting in accordance with APB 18, *The Equity Method of Accounting for Investments in Common Stock*.

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The following table discloses the changes in the carrying value of goodwill for the periods presented (dollars in thousands):

|  |              |
|--|--------------|
| Balance at December 31, 2005   | \$ 2,003,456 |
| Purchase accounting adjustments related to 2005 acquisitions                 | 16,711       |
| Addition from 2006 acquisition of RAA  | 13,739       |
| Additions from 2006 transition to equity method of accounting of Investsmart | 30,814       |
| Other adjustments  | (1,122)      |
| Balance at September 30, 2006  | \$ 2,063,598 |

During the third quarter, the Company completed the purchase of RAA, an investment advisor based in Dallas, Texas, and transitioned the Company's investment in Investsmart to equity method accounting as discussed in Note 9. In connection with these transactions, the Company recorded \$13.7 million and \$30.8 million in goodwill, respectively. An additional \$16.7 million of goodwill, primarily due to purchase accounting adjustments related to the 2005 acquisitions of BrownCo and Harrisdirect, was recorded for the nine months ended September 30, 2006.

**NOTE 11 DEPOSITS**

Deposits are summarized as follows (dollars in thousands):

|                                   | Weighted-Average Rate |                   | Amount             |                   | Percentage to Total |                   |
|-----------------------------------|-----------------------|-------------------|--------------------|-------------------|---------------------|-------------------|
|                                   | September 30, 2006    | December 31, 2005 | September 30, 2006 | December 31, 2005 | September 30, 2006  | December 31, 2005 |
| Sweep deposit accounts            | 0.87%                 | 0.57%             | \$ 10,351,653      | \$ 7,733,267      | 46.5%               | 48.5%             |
| Money market and savings accounts | 4.32%                 | 3.17%             | 6,391,190          | 4,635,866         | 28.6                | 29.1              |
| Certificates of deposit           | 4.95%                 | 3.94%             | 4,649,385          | 2,703,605         | 20.8                | 17.0              |
| Brokered certificates of deposit  | 3.70%                 | 3.86%             | 566,988            | 484,612           | 2.5                 | 3.0               |
| Checking accounts                 | 1.08%                 | 0.71%             | 360,148            | 390,665           | 1.6                 | 2.4               |
| Total deposits                    | 2.78%                 | 2.00%             | \$ 22,319,364      | \$ 15,948,015     | 100.0%              | 100.0%            |

**NOTE 12 ASSET SECURITIZATION*****Collateralized Debt Obligations ( CDO )***

On August 30, 2006, an unrelated financial advisor ( Advisor ) transferred \$229.9 million in asset-backed securities to E\*TRADE ABS CDO V, Ltd. ( CDO V ). The Company had previously transferred \$96.8 million in asset-backed securities to the Advisor for transfer to CDO V. Additionally, the Company utilized a warehouse line with the Advisor to purchase \$133.1 million of asset-backed securities that were also transferred to CDO V. Concurrent with these transfers, CDO V sold total beneficial interests of \$300.0 million to investors in the form of senior notes, subordinated notes and preference shares collateralized by the asset-backed securities. Additional purchases of asset-backed securities will be made in open market transactions and transferred to CDO V within 90 days following the closing date. As of September 30, 2006, 89% of the pool of underlying securities had been transferred into CDO V.

The CDO V transaction is a managed deal whereby the portfolio manager, E\*TRADE Global Asset Management, Inc., is appointed to actively manage the collateral of the CDO. Because CDO V is a managed deal, it is a special purpose entity and not a qualified special purpose entity. The CDO V transaction was accounted for as a sale in accordance with SFAS No. 140.



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The Company purchased \$2.2 million of preference shares in CDO V. Retained interests are subordinate to the notes sold by CDO V and on an equal standing with the preference shares purchased by other preference share investors in CDO V. Neither CDO V itself nor the investors in the beneficial interests sold by CDO V have recourse to the Company.

The Company reviewed CDO V to determine if consolidation was necessary under the requirements of FIN 46R. The calculation of CDO V's beneficial interests indicated that the Company was not the recipient of the majority of the potential benefits or losses of the deal. Therefore, the Company is not the primary beneficiary of the transaction and is not required to consolidate the CDO.

The following table summarizes the asset-backed securities transferred to CDO V at closing, the amount of the cash proceeds and the preference shares purchased by the Company (dollars in millions):

| CDO   | Transaction Date | Asset-Backed Securities Transferred to CDO at closing |                                   |          |          | Preference Shares                 |
|-------|------------------|---|-----------------------------------|----------|----------|-----------------------------------|
|       |                  | E* TRADE  | Independent<br>Investment Advisor | Total    | Proceeds | Purchased<br>by E*TRADE<br>Amount |
| CDO V | August 2006      | \$ 96.8   | \$ 133.1                          | \$ 229.9 | \$ 300.0 | \$ 2.2                            |

**Table of Contents****NOTE 13 EARNINGS PER SHARE**

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

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2006</b>                                 | <b>2005</b> | <b>2006</b>                                | <b>2005</b> |
| <b>Basic:</b>   |   |             |  |             |
| Numerator:  |   |             |  |             |
| Net income from continuing operations                             | \$ 150,228                                  | \$ 109,138  | \$ 449,904                                 | \$ 320,727  |
| Gain (loss) from discontinued operations, net of tax              | 3,021                                       | (3,293)     | 2,300                                      | (21,321)    |
| Cumulative effect of accounting change, net of tax                |   | 1,646       |  | 1,646       |
| Net income  | \$ 153,249                                  | \$ 107,491  | \$ 452,204                                 | \$ 301,052  |
| <b>Denominator:</b>   |   |             |  |             |
| Basic weighted-average shares outstanding                         | 423,736                                     | 367,342     | 420,148                                    | 366,215     |
| <b>Diluted:</b>   |   |             |  |             |
| Numerator:  |   |             |  |             |
| Net income  | \$ 153,249                                  | \$ 107,491  | \$ 452,204                                 | \$ 301,052  |
| Denominator:  |   |             |  |             |
| Basic weighted-average shares outstanding                         | 423,736                                     | 367,342     | 420,148                                    | 366,215     |
| Effect of dilutive securities:                                    |   |             |  |             |
| Weighted-average options and restricted stock issued to employees | 13,796                                      | 12,072      | 14,864                                     | 10,936      |
| Weighted-average warrants and contingent shares outstanding       | 248   | 2,617       | 248  | 2,617       |
| Weighted-average mandatorily convertible notes                    | 1,103                                       |             | 1,699                                      |             |
| Diluted weighted-average shares outstanding                       | 438,883                                     | 382,031     | 436,959                                    | 379,768     |
| <b>Per share:</b>   |   |             |  |             |
| Basic earnings per share:   |   |             |  |             |
| Earnings per share from continuing operations                     | \$ 0.35                                     | \$ 0.30     | \$ 1.07                                    | \$ 0.88     |
| Earnings (loss) per share from discontinued operations            | 0.01  | (0.01)      | 0.01                                       | (0.06)      |
| Earnings per share from cumulative effect of accounting change    |   | 0.00        |  | 0.00        |
| Net earnings per share  | \$ 0.36                                     | \$ 0.29     | \$ 1.08                                    | \$ 0.82     |
| <b>Diluted earnings per share:</b>                                |   |             |  |             |
| Earnings per share from continuing operations                     | \$ 0.34                                     | \$ 0.29     | \$ 1.03                                    | \$ 0.85     |
| Earnings (loss) per share from discontinued operations            | 0.01  | (0.01)      | 0.00                                       | (0.06)      |
| Earnings per share from cumulative effect of accounting change    |   | 0.00        |  | 0.00        |
| Net earnings per share  | \$ 0.35                                     | \$ 0.28     | \$ 1.03                                    | \$ 0.79     |

Excluded from the calculations of diluted earnings per share are 3.0 million shares of common stock for the nine months ended September 30, 2006 and 7.8 million shares for the three and nine months ended September 30, 2005, issuable under convertible subordinated notes as the effect of applying the treasury stock method on an if-converted basis would be anti-dilutive. There were not any shares excluded from the three months ended September 30, 2006, as all convertible subordinated notes outstanding had been redeemed by the end of the second quarter of 2006.



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

|   | Three Months Ended |          | Nine Months Ended |          |
|---|--------------------|----------|-------------------|----------|
|   | September 30,      |          | September 30,     |          |
|   | 2006               | 2005     | 2006              | 2005     |
| Options excluded from computation of diluted earnings per share | 6,656              | 3,427    | 4,822             | 9,877    |
| Exercise price ranges:  |                    |          |                   |          |
| High  | \$ 58.19           | \$ 58.19 | \$ 58.19          | \$ 58.19 |
| Low   | \$ 18.62           | \$ 8.04  | \$ 18.62          | \$ 4.15  |

**NOTE 14 SHARE REPURCHASES**

During 2006, the Company repurchased common stock under a \$200.0 million repurchase program approved by the Board in December 2004 (the December 2004 Plan). The December 2004 Plan is open-ended and provides the flexibility to buy back common stock, redeem for cash its outstanding convertible subordinated notes, retire debt in the open market or a combination of all three. The table below shows the timing and impact of the repurchases during the nine months ended September 30, 2006 (dollars in thousands, except per share amounts):

| Three Months       |                                  | Aggregate | Average Price |  | Maximum Dollar Value of Shares That May Yet be |
|--------------------|----------------------------------|-----------|---------------|--|--|
| Ended              | Total Number of Shares Purchased |           | Paid          |  |  |
|                    |                                  | Price     | per Share     |  | December 2004 Plan                             |
| March 31, 2006     |                                  | \$        | \$            |  | \$179,764                                      |
| June 30, 2006      | 2,029,500                        | \$48,273  | \$23.79       |  | \$131,491                                      |
| September 30, 2006 | 1,513,900                        | \$34,501  | \$22.79       |  | \$ 96,990                                      |

**NOTE 15 EMPLOYEE SHARE-BASED PAYMENTS AND OTHER BENEFITS**

Effective July 1, 2005, the Company adopted SFAS No. 123(R). The impact of the adoption resulted in expenses of \$7.1 million for stock options for the three and nine months ended September 30, 2005. The Company recognized \$6.2 million and \$20.0 million for the three and nine months ended September 30, 2006, respectively, in compensation expense for stock options.

The Company recorded a pre-tax credit of \$2.8 million in cumulative effect of accounting change and \$1.1 million compensation expense for the three months ended September 30, 2005. For the three and nine months ended September 30, 2006, the Company recognized \$2.2 million and \$7.6 million, respectively, in compensation expense for restricted stock awards. Prior to the adoption of SFAS No. 123(R), the Company previously accounted for restricted stock options under APB No. 25.

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The following table illustrates the effect on the Company's reported net income and earnings per share if the Company had applied the fair value recognition provision of SFAS No. 123 to stock-based employee compensation prior to the adoption of SFAS No. 123(R) (dollars in thousands, except per share amounts):

|   | <b>Six Months Ended</b> |         |
|---|-------------------------|---------|
|   | <b>June 30, 2005</b>    |         |
| Net income, as reported   | \$                      | 193,561 |
| Stock-based employee compensation expense, net of tax   |                         | 1,241   |
| Stock-based employee compensation expense determined under fair value-based method for all awards, net of tax |                         | (8,618) |
| Pro forma net income  | \$                      | 186,184 |
| Earnings per share:   |                         |         |
| Basic as reported   | \$                      | 0.53    |
| Basic pro forma   | \$                      | 0.51    |
| Diluted as reported   | \$                      | 0.51    |
| Diluted pro forma   | \$                      | 0.49    |

The fair value of each option award is estimated on the date of grant using a Black-Scholes-Merton option pricing model based on the assumptions noted in the table below. Expected volatility is based on a combination of historical volatility of the Company's stock and implied volatility of publicly traded options on the Company's stock. The expected term represents the period of time that options granted are expected to be outstanding. The expected term is estimated using employees' actual historical behavior and projected future behavior based on expected exercise patterns. The risk-free interest rate is based on the U.S. Treasury zero-coupon bond where the remaining term equals the expected term. Dividend yield is zero as the Company has not paid dividends to its shareholders and does not currently plan to pay dividends to its shareholders in the future.

|                         | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-------------------------|---------------------------|-------------|--------------------------|-------------|
|                         | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                         | <b>2006</b>               | <b>2005</b> | <b>2006</b>              | <b>2005</b> |
| Expected volatility     | 35%                       | 31%         | 34%                      | 34%         |
| Expected term (years)   | 4.44                      | 5.08        | 4.48                     | 4.89        |
| Risk-free interest rate | 5%                        | 4%          | 5%                       | 4%          |
| Dividend yield          |                           |             |                          |             |

The weighted-average fair values of options granted were \$8.67 and \$8.62 for the three and nine months ended September 30, 2006, respectively. The weighted-average fair values of options granted were \$5.56 and \$4.48 for the three and nine months ended September 30, 2005, respectively. The contractual term for most options granted during the three and nine months ended September 30, 2006 was 7 years. In previous periods, we primarily granted options with 10-year terms.

**NOTE 16 REGULATORY REQUIREMENTS*****Registered Broker-Dealers***

The Company's broker-dealer subsidiaries are subject to the Uniform Net Capital Rule (the "Rule") under the Securities Exchange Act of 1934 administered by the Securities and Exchange Commission ("SEC"), the New York Stock Exchange ("NYSE") and the NASD, Inc. ("NASD"), which requires the maintenance of minimum net capital. The minimum net capital requirements can be met under either the Aggregate Indebtedness method or the Alternative method. Under the Aggregate Indebtedness method, a broker-dealer is required to maintain minimum net capital of the

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greater of  $6\frac{2}{3}\%$  of its aggregate indebtedness, as defined, or a minimum dollar amount. Under the Alternative method, a broker-dealer is required to maintain net capital equal to the greater of \$250,000 or 2% of aggregate debit balances arising from customer transactions.

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

As of September 30, 2006, all of the Company's broker-dealer subsidiaries met minimum net capital requirements. Total required net capital was \$0.2 billion at September 30, 2006. In addition, the Company's broker-dealer subsidiaries had excess net capital of \$0.7 billion at September 30, 2006.

### Banking

E\*TRADE Bank (the "Bank") is subject to various regulatory capital requirements administered by Federal banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of Total and Tier I Capital to Risk-weighted assets and Tier I Capital to Adjusted total assets. As shown in the table below, at September 30, 2006, the most recent date of notification, the Office of Thrift Supervision ("OTS") categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. At September 30, 2006, management believes that the Bank meets all capital adequacy requirements to which it is subject. However, events beyond management's control, such as fluctuations in interest rates or a downturn in the economy in areas in which the Bank's loans or securities are concentrated, could adversely affect future earnings and the Bank's ability to meet its future capital requirements.

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

|   | Actual      |        | Minimum Required to<br>Qualify as Adequately<br>Capitalized |       | Minimum Required to be<br>Well Capitalized Under<br>Prompt Corrective<br>Action Provisions |         |
|---|-------------|--------|---|-------|--|---------|
|   | Amount      | Ratio  | Amount  | Ratio | Amount   | Ratio   |
| <b>September 30, 2006:</b>              |             |        |   |       |  |         |
| Total Capital to Risk-weighted assets   | \$2,384,494 | 10.61% | >\$ 1,798,510   | >8.0% | >\$2,248,138   | > 10.0% |
| Tier I Capital to Risk-weighted assets  | \$2,314,586 | 10.30% | >\$ 899,255   | >4.0% | >\$1,348,883   | > 6.0%  |
| Tier I Capital to Adjusted total assets | \$2,314,586 | 5.80%  | >\$ 1,595,949   | >4.0% | >\$1,994,936   | > 5.0%  |
| <b>December 31, 2005:</b>               |             |        |   |       |  |         |
| Total Capital to Risk-weighted assets   | \$2,021,091 | 10.94% | >\$ 1,478,238   | >8.0% | >\$1,847,797   | > 10.0% |
| Tier I Capital to Risk-weighted assets  | \$1,957,805 | 10.60% | >\$ 739,119   | >4.0% | >\$1,108,678   | > 6.0%  |
| Tier I Capital to Adjusted total assets | \$1,957,805 | 5.92%  | >\$ 1,322,343   | >4.0% | >\$1,652,929   | > 5.0%  |

### NOTE 17 COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS

#### Legal Matters

##### Litigation Matters

In June 2002, the Company acquired from MarketXT Holdings, Inc. (formerly known as "Tradescape Corporation") the following entities: Tradescape Securities, LLC; Tradescape Technologies, LLC; and Momentum Securities, LLC. Disputes subsequently arose between the parties regarding the responsibility for

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

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

### *Regulatory Matters*

The securities and banking industries are subject to extensive regulation under Federal, state and applicable international laws. As a result, the Company is required to comply with many complex laws and rules and its ability to comply is dependent in part on the establishment and maintenance of a qualified compliance system. From time to time, the Company has been threatened with, or named as a defendant in, lawsuits, arbitrations and administrative claims involving securities, banking and other matters. The Company is also subject to periodic

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regulatory audits and inspections. Compliance and trading problems that are reported to regulators, such as the SEC, the NYSE, the NASD or the OTS by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal claims being filed against the Company by customers or disciplinary action being taken against the Company or its employees by regulators. Any such claims or disciplinary actions that are decided against the Company could have a material impact on the financial results of the Company or any of its subsidiaries.

### *Insurance*

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

### *Reserves*

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

### *Commitments*

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

### *Loans*

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

|                 | September 30, 2006 |               |              |
|-----------------|--------------------|---------------|--------------|
|                 | Fixed Rate         | Variable Rate | Total        |
| Purchase loans  | \$ 378,610         | \$ 2,507,574  | \$ 2,886,184 |
| Originate loans | \$ 574,811         | \$ 273,284    | \$ 848,095   |
| Sell loans      | \$ 38,186          | \$ 8,799      | \$ 46,985    |

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

At September 30, 2006, the Company had commitments to purchase \$4.4 billion and sell \$5.6 billion in securities. In addition, the Company had approximately \$4.3 billion of certificates of deposit scheduled to mature in less than one year and \$9.1 billion of unfunded commitments to extend credit.

### *Guarantees*

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

The mortgage and the mortgage note have been duly executed and each is the legal, valid and binding obligation of the Company, enforceable in accordance with its terms. The mortgage has been duly acknowledged and recorded and is valid. The mortgage and the mortgage note are not subject to any



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right of rescission, set-off, counterclaim or defense, including, without limitation, the defense of usury, and no such right of rescission, set-off, counterclaim or defense has been asserted with respect thereto. If these claims prove to be untrue, the investor can require the Company to repurchase the loan and return all loan purchase and servicing release premiums.

Should any eligible mortgage loan delivered pay off prior to the receipt of the first payment, the loan purchase and servicing release premiums shall be fully refunded.

Should any eligible mortgage loan delivered to an investor pay off between the receipt of the first payment and a contractually designated period of time (typically 60 - 120 days from the date of purchase), the servicing release premiums shall be fully refunded. Management has determined that quantifying the potential liability exposure is not meaningful due to the nature of the standard representations and warranties, which rarely result in loan repurchases. The current carrying amount of the liability recorded at September 30, 2006 is \$0.2 million, which we consider adequate based upon analysis of historical trends and current economic conditions for these guarantees.

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

During the 30-year period prior to the redemption of the Floating Rate Cumulative Preferred Securities, ETBH guarantees the accrued and unpaid distributions on these securities, as well as the redemption price of the securities and certain costs that may be incurred in liquidating, terminating or dissolving the trusts (all of which would otherwise be payable by the trusts). At September 30, 2006, management estimated that the maximum potential liability under this arrangement is equal to approximately \$350.0 million or the total face value of these securities plus dividends, which may be unpaid at the termination of the trust arrangement.

## **NOTE 18 SEGMENT INFORMATION**

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

Retail includes:

investing, trading, banking and lending products and services to individuals; and

stock plan administration products and services.

Institutional includes:

balance sheet management activities including generation of institutional net interest spread, gain on sales of loans and securities, net and management income;

market-making; and

global equity execution and settlement services.

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

technology charges are allocated to segments either in proportion to their respective direct costs or based upon specific operating criteria.

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

|   | Retail     | Three Months Ended September 30, 2006 |                             | Total      |
|---|------------|---------------------------------------|-----------------------------|------------|
|   |            | Institutional                         | Eliminations <sup>(1)</sup> |            |
| Revenue:  |            |                                       |                             |            |
| Operating interest income                                     | \$ 397,998 | \$ 576,258                            | \$ (242,827)                | \$ 731,429 |
| Operating interest expense                                    | (176,939)  | (442,181)                             | 242,827                     | (376,293)  |
| Net operating interest income                                 | 221,059    | 134,077                               |                             | 355,136    |
| Provision for loan losses                                     |            | (12,547)                              |                             | (12,547)   |
| Net operating interest income after provision for loan losses | 221,059    | 121,530                               |                             | 342,589    |
| Commission  | 100,902    | 32,704                                |                             | 133,606    |
| Service charges and fees                                      | 28,790     | 5,120                                 |                             | 33,910     |
| Principal transactions  |            | 22,697                                |                             | 22,697     |
| Gain on sales of loans and securities, net                    | 10,608     | 5,395                                 |                             | 16,003     |
| Other revenue   | 30,942     | 2,771                                 | (752)                       | 32,961     |
| Total non-interest income                                     | 171,242    | 68,687                                | (752)                       | 239,177    |
| Total net revenue   | 392,301    | 190,217                               | (752)                       | 581,766    |
| Expense excluding interest:                                   |            |                                       |                             |            |
| Compensation and benefits                                     | 77,002     | 33,703                                |                             | 110,705    |
| Clearing and servicing  | 18,307     | 44,945                                | (752)                       | 62,500     |
| Advertising and market development                            | 22,517     | 1,397                                 |                             | 23,914     |
| Communications  | 22,248     | 3,328                                 |                             | 25,576     |
| Professional services   | 12,140     | 8,601                                 |                             | 20,741     |
| Depreciation and amortization                                 | 14,175     | 4,390                                 |                             | 18,565     |
| Occupancy and equipment                                       | 20,434     | 1,716                                 |                             | 22,150     |
| Amortization of other intangibles                             | 9,913      | 2,174                                 |                             | 12,087     |
| Facility restructuring and other exit activities              | 16,716     | (32)                                  |                             | 16,684     |
| Other   | 33,775     | 11,900                                |                             | 45,675     |
| Total expense excluding interest                              | 247,227    | 112,122                               | (752)                       | 358,597    |
| Segment income  | \$ 145,074 | \$ 78,095                             | \$                          | \$ 223,169 |

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

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|   | Three Months Ended September 30, 2005 |               |                             |            |
|---|---------------------------------------|---------------|-----------------------------|------------|
|   | Retail                                | Institutional | Eliminations <sup>(1)</sup> | Total      |
| Revenue:  |                                       |               |                             |            |
| Operating interest income                                     | \$ 175,330                            | \$ 362,547    | \$ (113,763)                | \$ 424,114 |
| Operating interest expense                                    | (63,223)                              | (257,641)     | 113,763                     | (207,101)  |
| Net operating interest income                                 | 112,107                               | 104,906       |                             | 217,013    |
| Provision for loan losses                                     |                                       | (12,909)      |                             | (12,909)   |
| Net operating interest income after provision for loan losses | 112,107                               | 91,997        |                             | 204,104    |
| Commission  | 83,755                                | 30,523        |                             | 114,278    |
| Service charges and fees                                      | 26,933                                | 5,960         |                             | 32,893     |
| Principal transactions  |                                       | 23,793        |                             | 23,793     |
| Gain on sales of loans and securities, net                    | 17,534                                | 4,316         |                             | 21,850     |
| Other revenue   | 27,927                                | 2,901         | (7,910)                     | 22,918     |
| Total non-interest income                                     | 156,149                               | 67,493        | (7,910)                     | 215,732    |
| Total net revenue   | 268,256                               | 159,490       | (7,910)                     | 419,836    |
| Expense excluding interest:                                   |                                       |               |                             |            |
| Compensation and benefits                                     | 58,899                                | 44,185        |                             | 103,084    |
| Clearing and servicing  | 10,690                                | 44,150        | (7,910)                     | 46,930     |
| Advertising and market development                            | 19,363                                | 1,825         |                             | 21,188     |
| Communications  | 15,390                                | 2,820         |                             | 18,210     |
| Professional services   | 10,757                                | 5,946         |                             | 16,703     |
| Depreciation and amortization                                 | 14,379                                | 4,064         |                             | 18,443     |
| Occupancy and equipment                                       | 14,271                                | 1,978         |                             | 16,249     |
| Amortization of other intangibles                             | 2,193                                 | 2,189         |                             | 4,382      |
| Facility restructuring and other exit activities              | (270)                                 | (199)         |                             | (469)      |
| Other   | 13,264                                | 9,865         |                             | 23,129     |
| Total expense excluding interest                              | 158,936                               | 116,823       | (7,910)                     | 267,849    |
| Segment income  | \$ 109,320                            | \$ 42,667     | \$                          | \$ 151,987 |

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

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|   | Nine Months Ended September 30, 2006 |               |                             |              |
|---|--------------------------------------|---------------|-----------------------------|--------------|
|   | Retail                               | Institutional | Eliminations <sup>(1)</sup> | Total        |
| Revenue:  |                                      |               |                             |              |
| Operating interest income                                     | \$ 1,088,932                         | \$ 1,532,902  | \$ (635,738)                | \$ 1,986,096 |
| Operating interest expense                                    | (433,247)                            | (1,164,060)   | 635,738                     | (961,569)    |
| Net operating interest income                                 | 655,685                              | 368,842       |                             | 1,024,527    |
| Provision for loan losses                                     |                                      | (33,014)      |                             | (33,014)     |
| Net operating interest income after provision for loan losses | 655,685                              | 335,828       |                             | 991,513      |
| Commission  | 364,333                              | 112,438       |                             | 476,771      |
| Service charges and fees                                      | 83,517                               | 16,023        |                             | 99,540       |
| Principal transactions  |                                      | 84,979        |                             | 84,979       |
| Gain on sales of loans and securities, net                    | 28,293                               | 10,445        |                             | 38,738       |
| Other revenue   | 101,813                              | 6,358         | (8,239)                     | 99,932       |
| Total non-interest income                                     | 577,956                              | 230,243       | (8,239)                     | 799,960      |
| Total net revenue   | 1,233,641                            | 566,071       | (8,239)                     | 1,791,473    |
| Expense excluding interest:                                   |                                      |               |                             |              |
| Compensation and benefits                                     | 228,561                              | 123,773       |                             | 352,334      |
| Clearing and servicing  | 55,796                               | 142,369       | (8,239)                     | 189,926      |
| Advertising and market development                            | 83,960                               | 5,155         |                             | 89,115       |
| Communications  | 75,251                               | 9,567         |                             | 84,818       |
| Professional services   | 52,626                               | 19,089        |                             | 71,715       |
| Depreciation and amortization                                 | 43,313                               | 12,868        |                             | 56,181       |
| Occupancy and equipment                                       | 57,904                               | 5,178         |                             | 63,082       |
| Amortization of other intangibles                             | 29,600                               | 5,791         |                             | 35,391       |
| Facility restructuring and other exit activities              | 19,915                               | (600)         |                             | 19,315       |
| Other   | 74,816                               | 27,072        |                             | 101,888      |
| Total expense excluding interest                              | 721,742                              | 350,262       | (8,239)                     | 1,063,765    |
| Segment income  | \$ 511,899                           | \$ 215,809    | \$                          | \$ 727,708   |

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

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|   | Nine Months Ended September 30, 2005 |               |                             |              |
|---|--------------------------------------|---------------|-----------------------------|--------------|
|   | Retail                               | Institutional | Eliminations <sup>(1)</sup> | Total        |
| Revenue:  |                                      |               |                             |              |
| Operating interest income                                     | \$ 464,066                           | \$ 983,789    | \$ (299,471)                | \$ 1,148,384 |
| Operating interest expense                                    | (161,581)                            | (673,260)     | 299,309                     | (535,532)    |
| Net operating interest income                                 | 302,485                              | 310,529       | (162)                       | 612,852      |
| Provision for loan losses                                     |                                      | (37,946)      |                             | (37,946)     |
| Net operating interest income after provision for loan losses | 302,485                              | 272,583       | (162)                       | 574,906      |
| Commission  | 235,759                              | 87,352        |                             | 323,111      |
| Service charges and fees                                      | 86,683                               | 13,956        |                             | 100,639      |
| Principal transactions  |                                      | 75,386        | 161                         | 75,547       |
| Gain on sales of loans and securities, net                    | 51,746                               | 32,375        |                             | 84,121       |
| Other revenue   | 82,174                               | 8,412         | (23,990)                    | 66,596       |
| Total non-interest income                                     | 456,362                              | 217,481       | (23,829)                    | 650,014      |
| Total net revenue   | 758,847                              | 490,064       | (23,991)                    | 1,224,920    |
| Expense excluding interest:                                   |                                      |               |                             |              |
| Compensation and benefits                                     | 171,936                              | 108,536       |                             | 280,472      |
| Clearing and servicing  | 30,347                               | 126,364       | (23,991)                    | 132,720      |
| Advertising and market development                            | 66,844                               | 7,408         |                             | 74,252       |
| Communications  | 46,585                               | 8,065         |                             | 54,650       |
| Professional services   | 37,904                               | 15,264        |                             | 53,168       |
| Depreciation and amortization                                 | 43,326                               | 9,984         |                             | 53,310       |
| Occupancy and equipment                                       | 41,702                               | 8,971         |                             | 50,673       |
| Amortization of other intangibles                             | 6,926                                | 6,825         |                             | 13,751       |
| Facility restructuring and other exit activities              | (170)                                | 665           |                             | 495          |
| Other   | 32,879                               | 33,038        |                             | 65,917       |
| Total expense excluding interest                              | 478,279                              | 325,120       | (23,991)                    | 779,408      |
| Segment income  | \$ 280,568                           | \$ 164,944    | \$                          | \$ 445,512   |

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

*Segment Assets*

|                          | Retail        | Institutional | Eliminations | Total         |
|--------------------------|---------------|---------------|--------------|---------------|
| As of September 30, 2006 | \$ 13,085,301 | \$ 38,437,870 | \$           | \$ 51,523,171 |
| As of December 31, 2005  | \$ 12,901,008 | \$ 31,666,678 | \$           | \$ 44,567,686 |

No single customer accounted for more than 10% of total net revenue for the three or nine months ended September 30, 2006 or 2005.

**NOTE 19 SUBSEQUENT EVENTS**

On October 9, 2006, the Company announced, through its wholly owned subsidiary E\*TRADE Mauritius Limited, that it is making an open offer (the "Offer") to purchase additional shares of Investsmart. If the Offer is accepted by Investsmart shareholders, the Company may acquire up to an additional 20% of Investsmart's Emerging Voting Capital per equity share, which if fully subscribed, would increase the Company's fully paid up voting capital of Investsmart to as much as 48%.



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**ITEM 4. CONTROLS AND PROCEDURES**

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

**Table of Contents****PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

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

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

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

**Table of Contents****ITEM 1A. RISK FACTORS**

The updated and additional risk factor presented below should be considered in addition to the risk factors previously disclosed in our 2005 Annual Report on Form 10-K.

*We rely heavily on technology, and technology can be subject to interruption or fraud*

We rely on technology, particularly the Internet, to conduct most of our activity. Our technology operations are vulnerable to disruptions from human error, natural disasters, power loss, computer viruses, spam attacks, unauthorized access and other similar events. Disruptions to or instability of our technology could harm our business and our reputation. In addition, technology systems, whether they be our own proprietary systems or the systems of third parties on whom we rely to conduct portions of our operations can be vulnerable to unique acts of fraud involving the compromise of computer systems. An actual or perceived breach of the security of our technology could harm our business and our reputation.

*Vulnerability of our customers' computers could lead to significant losses related to identity theft or other fraud and harm our reputation*

Because our business model relies heavily on our customers' use of their own personal computers and the Internet, our business and reputation could be harmed by perceptions arising from the security breaches of third parties, including those of our own customers. Recent computer viruses attacking the computers of our customers could create losses for our customers even without any breach in the security of our systems, and could thereby harm our business and our reputation. We have reimbursed customers for losses caused by a breach of security, including the security of customers' own systems, in accordance with the terms of our Complete Protection Guaranty and such reimbursed losses could have a material impact on our financial performance in a given period.

There have been no other material changes in our risk factors from those disclosed in our 2005 Annual Report on Form 10-K.

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

On December 15, 2004, the Company announced that its Board of Directors approved a \$200.0 million repurchase plan (the December 2004 Plan). The December 2004 Plan is open-ended and provides the flexibility to buy back common stock, retire debt or a combination of both. The Company may conduct these repurchases on the open market, in private transactions or a combination of both.

During the three months ended September 30, 2006, the Company used the December 2004 Plan to repurchase the Company's common stock as follows:

| Month          | Total Number of<br>Shares Purchased | Average Price Paid<br>per Share | Total Number of<br>Shares Purchased<br>as Part of the<br>December 2004 Plan | Maximum Dollar Value<br>of Shares That May Yet<br>be Purchased Under the<br>December 2004 Plan |
|----------------|-------------------------------------|---------------------------------|---|--|
| July 2006      | 100,000                             | \$ 22.94                        | 100,000   | \$ 129,197,060   |
| August 2006    | 1,083,900                           | \$ 22.85                        | 1,083,900   | \$ 104,434,911   |
| September 2006 | 330,000                             | \$ 22.56                        | 330,000   | \$ 96,990,247  |
| Total          | 1,513,900                           | \$ 22.79                        | 1,513,900   | \$ 96,990,247  |

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

\*31.1 Certification Section 302 of the Sarbanes-Oxley Act of 2002

\*31.2 Certification Section 302 of the Sarbanes-Oxley Act of 2002

\*32.1 Certification Section 906 of the Sarbanes-Oxley Act of 2002

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\* Filed herein.

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**SIGNATURES**

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

Dated: November 7, 2006

E\*TRADE Financial Corporation

(Registrant)

By                    /s/    MITCHELL H. CAPLAN  
                         Mitchell H. Caplan

*Chief Executive Officer*

By                    /s/    ROBERT J. SIMMONS

Robert J. Simmons

*Chief Financial Officer*

*(Principal Financial and Accounting Officer)*