BEAR STEARNS COMPANIES INC
Form 10-Q
April 14, 2008

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

FORM 10-Q

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

For the quarterly period ended February 29, 2008

or

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

For the transition period from ___________ to ___________

Commission file number 1-8989

The Bear Stearns Companies Inc.

(Exact name of registrant as specified in its charter)

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [ ] (Do not check if a smaller reporting company)

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

As of April 8, 2008, the latest practicable date, there were 145,698,482 shares of Common Stock, $1 par value, outstanding.

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AVAILABLE INFORMATION

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

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

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

PART I - FINANCIAL INFORMATION
Item 1. Financial Statements

THE BEAR STEARNS COMPANIES INC.

Condensed Consolidated Statements of Income

(in millions, except share and per share data)	(Unaudited) Three Months Ended February 29, 2008	February 28, 2007
REVENUES		
Commissions	$ 330	$ 281
Principal transactions	515	1,342
Investment banking	230	350
Interest and dividends	2,198	2,657

Asset management and other income	154	168
Total revenues	3,427	4,798
Interest expense	1,948	2,316
Revenues, net of interest expense	1,479	2,482
NON-INTEREST EXPENSES		
Employee compensation and benefits	754	1,204
Floor brokerage, exchange and clearance fees	79	56
Communications and technology	154	128
Occupancy	73	57
Advertising and market development	40	37
Professional fees	100	72
Other expenses	126	93
Total non-interest expenses	1,326	1,647
Income before provision for income taxes	153	835
Provision for income taxes	38	281
Net income	$ 115	$ 554
Preferred stock dividends	5	6
Net income applicable to common shares	$ 110	$ 548
Basic earnings per share	$ 0.89	$ 4.23
Diluted earnings per share	$ 0.86	$ 3.82
Weighted average common shares outstanding:		
Basic	129,128,281	133,094,747
Diluted	138,539,248	149,722,654
Cash dividends declared per common share	$ 0.32	$ 0.32

See Notes to Condensed Consolidated Financial Statements.

THE BEAR STEARNS COMPANIES INC.

Condensed Consolidated Statements of
Financial Condition

(in millions, except share data)

ASSETS

Cash and cash equivalents

Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations

Securities received as collateral

Collateralized agreements:

Securities purchased under agreements to resell

Securities borrowed

Receivables:

Customers

Brokers, dealers and others

Interest and dividends

Financial instruments owned, at fair value

Financial instruments owned and pledged as collateral, at fair value

Total financial instruments owned, at fair value

Assets of variable interest entities and mortgage loan special purpose entities

Property, equipment and leasehold improvements, net of accumulated depreciation and amortization of $1,196 and $1,149 as of February 29, 2008 and November 30, 2007, respectively

Other assets

Total Assets

LIABILITIES AND STOCKHOLDERS' EQUITY

Unsecured short-term borrowings (includes $434 and $339 at fair value as of February 29, 2008 and November 30, 2007, respectively)

Obligation to return securities received as collateral

Collateralized financings:

Securities sold under agreements to repurchase

Securities loaned

Other secured borrowings

Payables:

Customers

Brokers, dealers and others

Interest and dividends

Financial instruments sold, but not yet purchased, at fair value

Liabilities of variable interest entities and mortgage loan special purpose entities

Accrued employee compensation and benefits

Other liabilities and accrued expenses

Long-term borrowings (includes $9,018 and $8,500 at fair value as of February 29, 2008 and November 30, 2007, respectively)

Total Liabilities

Commitments and contingencies (Note 12)

STOCKHOLDERS' EQUITY

Preferred stock

Common stock, $1.00 par value; 500,000,000 shares authorized and 184,805,847 shares issued as of both February 29, 2008 and November 30, 2007
Paid-in capital
Retained earnings
Employee stock compensation plans
Accumulated other comprehensive income (loss)
Shares held in RSU trust
Treasury stock, at cost:
Common stock: 39,135,671 and 71,807,227 shares as of February 29, 2008 and November 30, 2007, respectively

Total Stockholders' Equity

Total Liabilities and Stockholders' Equity

See Notes to Condensed Consolidated Financial Statements.

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THE BEAR STEARNS COMPANIES INC.

Condensed Consolidated Statements of Cash Flows

(in millions)

CASH FLOWS FROM OPERATING ACTIVITIES

Net income	$
Adjustments to reconcile net income to cash used in operating activities:	
Non-cash items included in net income:	
Depreciation and amortization	
Employee stock compensation plans	
Changes in operating assets and liabilities:	
Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations	
Securities borrowed, securities loaned, net	
Receivables from customers	
Receivables from brokers, dealers and others	
Financial instruments owned, at fair value	
Other assets	
Securities sold under agreements to repurchase, securities purchased under agreements to resell, net	
Payables to customers	
Payables to brokers, dealers and others	
Financial instruments sold, but not yet purchased, at fair value	
Accrued employee compensation and benefits	
Other liabilities and accrued expenses	

Cash provided by (used in) operating activities

CASH FLOWS FROM INVESTING ACTIVITIES
Purchases of property, equipment and leasehold improvements, net

Cash used in investing activities

CASH FLOWS FROM FINANCING ACTIVITIES
Payments for/proceeds from unsecured short-term borrowings, net
Payments for other secured borrowings, net
Proceeds from issuance of long-term borrowings
Payments for retirement/repurchase of long-term borrowings
Payments for/proceeds from issuances of derivatives with a financing element, net
Issuance of common stock
Cash retained resulting from tax deductibility under share-based payment arrangements
Treasury stock purchases - common stock
Cash dividends paid

Cash (used in) provided by financing activities

Net (decrease) increase in cash and cash equivalents
Cash and cash equivalents, beginning of year

Cash and cash equivalents, end of period $

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:
Cash payments for interest were $2.32 billion and $2.51 billion during the three months ended February 29, 2008 and February 28, 2007, respectively. Cash payments for income taxes, net of an approximate $325 million refund of November 30, 2007 estimated Federal taxes, was ($294.0) million for the three months ended February 29, 2008 and cash payments for income taxes, net of refunds, was $108.8 million for the three months ended February 28, 2007. Cash payments for income taxes, net of an approximate $325 million refund of November 30, 2007 estimated Federal taxes, would have been ($249.0) million for the three months ended February 29, 2008 if increases in the value of equity instruments issued under share-based payment arrangements had not been deductible in determining taxable income. Cash payments for income taxes, net of refunds, would have been $313.9 million for the three months ended February 28, 2007 if increases in the value of equity instruments issued under share-based payment arrangements had not been deductible in determining taxable income.

See Notes to Condensed Consolidated Financial Statements.

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THE BEAR STEARNS COMPANIES INC.

Condensed Consolidated Statements of
Comprehensive Income

(in millions)	(Unaudited) Three months ended February 29, 2008	February 28, 2007
Net Income	$ 115	$ 554
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustment	(2)	--
Net gains on cash flow hedges	35	--
Comprehensive income	$ 148	$ 554

See Notes to Condensed Consolidated Financial Statements.

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

The Bear Stearns Companies Inc. (the "Company") is a holding company that, through its broker-dealer and international bank subsidiaries, principally Bear, Stearns & Co. Inc. ("Bear Stearns"), Bear, Stearns Securities Corp. ("BSSC"), Bear, Stearns International Limited ("BSIL") and Bear Stearns Bank plc ("BSB"), is primarily engaged in business as a securities broker-dealer operating in three principal segments: Capital Markets, Global Clearing Services and Wealth Management. Capital Markets is comprised of the institutional equities, fixed income and investment banking areas. Global Clearing Services provides clearance-related services for prime brokerage clients and clearance on a fully disclosed basis for introducing broker-dealers. Wealth Management is comprised of the private client services ("PCS") and asset management areas. See Note 15, "Segment Data," in the Notes to Condensed Consolidated Financial Statements for a complete description of the Company's principal segments. The Company also conducts significant activities through other wholly owned subsidiaries, including: Bear Stearns Global Lending Limited; Bear Stearns Bank & Trust Company (formerly known as Custodial Trust Company); Bear Stearns Financial Products Inc. ("BSFP"); Bear Stearns Capital Markets Inc.; Bear Stearns Credit Products Inc.; Bear Stearns Forex Inc. ("BS Forex"); EMC Mortgage Corporation; Bear Stearns Commercial Mortgage, Inc.; Bear Stearns Investment Products Inc.; and Bear Energy L.P.

Subsequent Events

The Company experienced a significant liquidity crisis during the end of the week of March 10, 2008 that seriously jeopardized its financial viability and which raises substantial doubt about its ability to continue as a going concern. As a result, on March 16, 2008, the Company and JPMorgan Chase & Co. ("JPMorgan Chase") entered into an agreement and plan of merger, and on March 24, 2008, entered into an amendment to the

agreement and plan of merger (as amended the "Merger Agreement'). Pursuant to the Merger Agreement each share of the Company's common stock outstanding immediately prior to the merger will be exchanged for 0.21753 shares of JPMorgan Chase common stock. A summary of the Merger Agreement, related transaction documents and the accounting implications are described in more detail in the Transaction Documents and Accounting Implications sections of Note 17, "Subsequent Events," of Notes to Condensed Consolidated Financial Statements.

In connection with the entry into the amendment to the Merger Agreement, the Company and JPMorgan Chase entered into a share exchange agreement under which JPMorgan Chase will purchase 95 million newly issued shares of the Company's common stock, or 39.5% of the outstanding common stock of the Company after giving effect to the issuance, in exchange for the issuance of 20,665,350 shares of JPMorgan Chase common stock to the Company and the entry by JPMorgan Chase into an amended and restated guaranty agreement and the guaranty agreement with the Federal Reserve Bank of New York ("New York Fed"). The share exchange was completed on April 8, 2008.

Concurrent with the closing of the merger, the New York Fed will take, through a limited liability company formed for this purpose, control of a portfolio of $30 billion in assets of the Company based on the value of the portfolio as of March 14, 2008. The assets will be funded by a $29 billion, 10-year term note from the New York Fed, and a $1 billion, 10-year subordinated note from JPMorgan Chase. The JPMorgan Chase note is subordinated to the New York Fed loan and will bear the first $1 billion of any losses associated with the assets. Any funds remaining after payment of the New York Fed loan, the JPMorgan Chase note and other expenses of the limited liability company, will be paid to the New York Fed.

Since the liquidity crisis and the announcement of the merger, the Company has experienced substantial deterioration of its earnings capacity. The closing of the merger is expected to occur by June 30, 2008. The Company believes that the termination of the JPMorgan Chase guaranties prior to consummation of the merger or the parties' failure to consummate the merger could seriously jeopardize the Company's financial viability. In addition, absent the Guaranty, the Company could face the increased risk of rapid loss of customers and counterparties. The lack of liquidity and the loss of customers and counterparties would materially adversely affect the Company's financial stability and its viability as a going concern. Accordingly, the Company could be forced to file for bankruptcy protection and need to liquidate. The accompanying Condensed Consolidated Financial

Statements do not reflect any adjustments that might result if the Company were unable to continue as a going concern.

Basis of Presentation

The Condensed Consolidated Financial Statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the

Company has a controlling financial interest. All material intercompany transactions and balances have been eliminated in consolidation.

The Company determines whether it has a controlling financial interest in an entity by evaluating whether an entity is a voting interest entity, a variable interest entity ("VIE") or a qualifying special purpose entity ("QSPE") under generally accepted accounting principles.

Voting interest entities are consolidated in accordance with Accounting Research Bulletin ("ARB") No. 51, "Consolidated Financial Statements," as amended. ARB No. 51 states that the usual condition for a controlling financial interest in an entity is ownership of a majority voting interest. Accordingly, the Company consolidates voting interest entities in which it has a majority voting interest. VIEs are entities that lack one or more of the characteristics of a voting interest entity. A controlling financial interest in a VIE occurs when an entity has a variable interest that will absorb a majority of the VIEs expected losses, receive a majority of the VIEs residual returns, or both. The entity with the controlling financial interest, known as the primary beneficiary, consolidates the VIE. In accordance with Financial Accounting Standards Board ("FASB") Interpretation ("FIN") No. 46 (R), "Consolidation of Variable Interest Entities (revised December 2003)--an interpretation of Accounting Research Bulletin ("ARB") No. 51" ("FIN No. 46 (R)"), the Company consolidates any variable interest entities for which it is the primary beneficiary. The assets and related liabilities of such variable interest entities have been shown in the Condensed Consolidated Statements of Financial Condition in the captions "Assets of variable interest entities and mortgage loan special purpose entities" and "Liabilities of variable interest entities and mortgage loan special purpose entities." See Note 5, "Variable Interest Entities and Mortgage Loan Special Purpose Entities," in the Notes to Condensed Consolidated Financial Statements. QSPEs are passive entities that are commonly used in securitization transactions. Statement of Financial Accounting Standards ("SFAS") No. 140, "Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," sets forth the criteria an entity must satisfy to be a QSPE. In accordance with SFAS No. 140, the Company does not consolidate QSPEs.

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

The Company follows Emerging Issues Task Force ("EITF") Issue No. 04-5 "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." The EITF consensus requires a general partner in a limited partnership to consolidate the limited partnership unless the presumption of control is overcome. The general partner may overcome this presumption of control and not consolidate the entity if the limited partners have: (a) the substantive ability to dissolve or liquidate the limited partnership or otherwise remove the general partner without having to show cause; or (b) substantive participating rights in managing the partnership.

The Condensed Consolidated Statement of Financial Condition as of February 29, 2008, the Condensed Consolidated Statements of Income, Cash Flows, and Comprehensive Income for the three months ended February 29, 2008 and February 28, 2007 are unaudited. The Condensed Consolidated Statement of Financial Condition at November 30, 2007 and related information were derived from the audited consolidated financial statements included in the Company's Current Report on Form 8-K, which was filed with the Securities and Exchange Commission ("SEC") on April 11, 2008 (the "Form 8-K").

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

The Condensed Consolidated Financial Statements are prepared in accordance with the rules and regulations of the SEC with respect to the Quarterly Report on Form 10-Q and reflect all adjustments which, in the opinion of management, are normal and recurring, and which are necessary for a fair statement of the results for the interim periods presented. In accordance with such rules and regulations, certain disclosures that are normally included in annual financial statements have been omitted. These Condensed Consolidated Financial Statements should be read together with the Form 8-K.

The Condensed Consolidated Financial Statements are prepared in conformity with accounting principles generally accepted in the United States of America. These principles require management to make certain estimates and assumptions, including those regarding fair value measurements, stock-based compensation, certain accrued liabilities, the potential outcome of litigation and tax matters, and the realizability of deferred tax assets, which may affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Actual results could differ materially from these estimates. The nature of the Company's business is such that the results of any interim period may not be indicative of the results to be expected for an entire fiscal year.

Revenue Recognition Policies

Principal Transactions

Financial instruments owned and financial instruments sold, but not yet purchased, including contractual commitments arising pursuant to futures, forward and option contracts, interest rate swaps and other derivative contracts, are recorded at fair value with the resulting net unrealized gains and losses reflected in "Principal transactions" revenues in the Condensed Consolidated Statements of Income.

Investment Banking and Advisory Services

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

Mortgage Servicing Fees and Advances

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

mortgagors, related securitization trusts or from the proceeds received from the sales of the underlying properties. A charge to earnings is recognized to the extent that servicing advances are estimated to be uncollectible under the provisions of the servicing contracts.

Commissions

Commission revenues primarily include fees from executing and clearing client transactions on stock, options and futures markets worldwide. These fees are recognized on a trade date basis. The Company records its share of the commission under certain clearing agreements where the Company is acting as agent for another broker, in accordance with EITF Statement No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent."

Asset Management and Other Income

The Company receives advisory fees for investment management. In addition, the Company receives performance incentive fees for managing certain funds. Advisory fees are recognized over the period of advisory service. Unearned advisory fees are treated as deferred revenues and are included in "Other liabilities" in the accompanying Condensed Consolidated Statements of Financial Condition. Performance incentive fees are accrued throughout the year based on a fund's performance to date against specified performance targets.

Energy Trading

Energy trading revenues are reported, net of certain direct costs, in "Principal transactions" revenues on the Condensed Consolidated Statements of Income. Energy trading assets and liabilities that are derivatives are reported at fair value with the corresponding changes recognized in income. Non-derivative contracts are accounted for on an accrual basis and recognized in income when the energy is delivered. See Note 16, "Asset Acquisition" for a further discussion on the assets acquired from the Williams Power Company, Inc.

Financial Instruments

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

Financial instruments owned and financial instruments sold, but not yet purchased, including contractual commitments arising pursuant to futures, forward and option contracts, interest rate swaps and other derivative contracts, are recorded on a trade-date basis at fair value.

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

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

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115," which provides a fair value option election that permits entities to irrevocably elect to measure financial assets and liabilities (except for those that are specifically scoped out of the Statement) at fair value as the initial and subsequent measurement attribute, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument.

Effective December 1, 2007, the Company adopted SFAS No. 159 and elected to apply the fair value option to liabilities of variable interest entities and mortgage loan special purpose entities. The primary reason for electing the fair value option is to simplify the accounting requirements. The Company did not have a transition adjustment upon the adoption of this Statement.

Derivative Instruments and Hedging Activities

The Company follows SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," and SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which establishes accounting and reporting standards for stand-alone derivative instruments, derivatives embedded within other

contracts or securities, and hedging activities. Accordingly, all

derivatives, whether stand-alone or embedded within other contracts or securities, are carried in the Company's Condensed Consolidated Statements of Financial Condition at fair value, with changes in fair value recorded in "Principal transactions" revenues. Designated hedged items in fair value hedging relationships are marked for the risk being hedged, with such changes also recorded in "Principal transactions" revenues. Derivatives designated as cash flow hedges are carried at fair value. The effective portion of the change in fair value on a derivative designated as a cash flow hedge is reported in "Accumulated other comprehensive income (loss)." The ineffective portion is reported in "Principal transactions" revenues in the Condensed Consolidated Statements of Income. Amounts that are reported in "Accumulated other comprehensive income (loss)" are reclassified into earnings in the same period or periods during which the hedged transaction affects earnings.

The Company follows SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140." SFAS No. 155 permits companies to elect on an instrument-by-instrument basis, to apply a fair value measurement to hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation under SFAS No. 133. As permitted, on December 1, 2006, the Company elected to apply a fair value measurement to all existing hybrid financial instruments that met the SFAS No. 155 definition. The Company also elected the fair value measurement for certain qualifying hybrid financial instruments issued on or after December 1, 2006. The Company's reason for electing to carry these instruments on a fair value basis was to enable the Company to more efficiently hedge these instruments and to simplify the accounting process. Changes in fair value are reflected in "Principal transactions" revenues in the Condensed Consolidated Statements of Income.

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

In April 2007, the FASB issued Staff Position ("FSP") FIN No. 39-1, "Amendment of FASB Interpretation No. 39." FSP FIN No. 39-1 defines "right of setoff" and specifies what conditions must be met for a derivative contract to qualify for this right of setoff. It also addresses the applicability of a right of setoff to derivative instruments and clarifies the circumstances in which it is appropriate to offset amounts recognized for those instruments in the Condensed Consolidated Statement of Financial Condition. In addition, this FSP permits offsetting of fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting arrangement and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments. The provisions of this FSP are consistent with the Company's current accounting practice. The Company adopted the provisions of FSP FIN No. 39-1 on December 1, 2007. The adoption of FSP FIN No. 39-1 did not impact the condensed consolidated financial statements of the Company.

Customer Transactions

Customer securities transactions are recorded on the Condensed Consolidated Statements of Financial Condition on a settlement date basis, which is generally three business days after trade date, while the related commission revenues and expenses are recorded on a trade date basis.

Receivables from and payables to customers include amounts related to both cash and margin transactions. Securities owned by customers, including those that collateralize margin or other similar transactions, are generally not reflected in the Condensed Consolidated Statements of Financial Condition.

Mortgage Servicing Rights

Mortgage servicing rights ("MSRs") are included in "Other assets" on the Condensed Consolidated Statements of Financial Condition. The Company follows SFAS No. 156, "Accounting for Servicing of Financial Assets--an amendment of FASB Statement No. 140," and measures servicing assets at fair value. The fair value of MSRs is determined by using market-based models that discount anticipated future net cash flows considering loan

prepayment predictions, interest rates, default rates, servicing costs, current market data and other economic factors. Changes in the fair value of MSRs are recorded in "Principal transactions" revenues in the Condensed Consolidated Statements of Income.

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

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

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

Collateralized Securities Transactions

Transactions involving purchases of securities under agreements to resell ("reverse repurchase agreements") or sales of securities under agreements to repurchase ("repurchase agreements") are treated as collateralized financing transactions and are recorded at their contracted resale or repurchase amounts plus accrued interest. Resulting interest income and expense is generally included in "Principal transactions" revenues in the

Condensed Consolidated Statements of Income. Reverse repurchase agreements and repurchase agreements are presented in the Condensed Consolidated Statements of Financial Condition on a net-by-counterparty basis, where permitted by generally accepted accounting principles. It is the Company's general policy to take possession of securities or loans with a market value in excess of the principal amount loaned plus the accrued interest thereon, in order to collateralize reverse repurchase agreements. Similarly, the Company is generally required to provide securities or loans to counterparties to collateralize repurchase agreements. The Company's agreements with counterparties generally contain contractual provisions allowing for additional collateral to be obtained, or excess collateral returned. It is the Company's policy to value collateral and to obtain additional collateral, or to retrieve excess collateral from counterparties, when deemed appropriate.

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

Fixed Assets

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

Goodwill and Identifiable Intangible Assets

The Company accounts for goodwill and identifiable intangible assets under the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets." In accordance with this guidance, the Company does not amortize goodwill, but amortizes identifiable intangible assets over their useful lives. Goodwill is tested at least annually for impairment and identifiable intangible assets are tested for potential impairment whenever events or changes in

circumstances suggest that the carrying value of an asset or asset group may not be fully recoverable in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." See Note 17, "Subsequent Events," of Notes to the Condensed Consolidated Financial Statements for further discussion.

Earnings Per Share

Earnings per share ("EPS") is computed in accordance with SFAS No. 128, "Earnings Per Share." Basic EPS is computed by dividing net income applicable to common shares, adjusted for costs related to vested shares under the Capital Accumulation Plan for Senior Managing Directors, as amended and restated ("CAP Plan"), as well as the effect of the redemption of preferred stock, by the weighted average number of common shares outstanding. Common shares outstanding includes vested units issued under certain stock compensation plans, which will be distributed as shares of common stock. Diluted EPS includes the determinants of basic EPS and, in addition, gives effect to dilutive potential common shares related to stock compensation plans.

Stock-Based Compensation

The Company follows SFAS No. 123 (R), "Share-Based Payment," to account for its stock-based compensation plans. SFAS No. 123 (R) is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and amends SFAS No. 95, "Statement of Cash Flows." SFAS No. 123 (R) eliminated the ability to account for share-based compensation transactions using APB No. 25, and requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements using a fair value-based method.

Cash Equivalents

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

Income Taxes

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN No. 48"). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted the provisions of FIN No. 48 in the first quarter of 2008. See Note 13, "Income Taxes," of the Notes to Condensed Consolidated Financial Statements for a further discussion.

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

Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at period end rates of exchange, while income statement items are translated at daily average rates of exchange during the fiscal period. Gains or losses on translation of the financial statements of foreign subsidiaries from their respective functional currency to the U.S. dollar are included, net of tax, on the Condensed Consolidated Statements of Comprehensive

Income. Gains or losses resulting from foreign currency transactions are included in current earnings.

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Accounting and Reporting Developments

In March 2008, the FASB issued Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133." The Statement requires companies to provide enhanced disclosures regarding derivative instruments and hedging activities. It requires companies to better convey the purpose of derivative use in terms of the risks that such company is intending to manage. Disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows are required. This Statement retains the same scope as SFAS No. 133 and is effective for fiscal years and interim periods beginning after November 15, 2008. The Company is currently assessing implementation plans and does not expect the adoption of SFAS No. 161 to have a material impact, if any, on the Condensed Consolidated Financial Statements.

In February 2008, the FASB issued a FASB Staff Position ("FSP") on Accounting for Transfers of Financial Assets and Repurchase Financing Transactions "FSP FAS 140-3." This FSP addresses the issue of whether or not these transactions should be viewed as two separate transactions or as one "linked" transaction. The FSP includes a "rebuttable presumption" that presumes linkage of the two transactions unless the presumption can be overcome by meeting certain criteria. The FSP will be effective for fiscal years beginning after November 15, 2008 and will apply only to original transfers made after that date; early adoption will not be allowed. The Company is currently evaluating the impact, if any, the adoption of this interpretation will have on the Company's Condensed Consolidated Financial Statements.

In December 2007, the FASB issued Statement No. 141R, "Business Combinations (a revision of Statement No. 141)." This Statement applies to all transactions or other events in which an entity obtains control of one or more businesses, including those combinations achieved without the transfer of consideration. This Statement retains the fundamental requirements in Statement No. 141 that the acquisition method of accounting be used for all business combinations. This Statement expands the scope to include all business combinations and requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their fair values as of the acquisition date. Additionally, SFAS No. 141R changes the way entities account for business combinations achieved in stages by requiring the identifiable assets and liabilities to be measured at their full fair values. Additionally, contractual contingencies and contingent consideration shall be measured at fair value at the acquisition date. This Statement is effective on a prospective basis to business combinations for which the acquisition date is on or after the beginning

of the first annual reporting period beginning on or after December 15, 2008. The Company is currently evaluating the impact, if any, that the adoption of this Statement will have on the Condensed Consolidated Financial Statements of the Company.

In December 2007, the FASB issued Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51". This Statement amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Additionally, this Statement requires that consolidated net income include the amounts attributable to both the parent and the noncontrolling interest. This Statement is effective for interim periods beginning on or after December 15, 2008. The Company is currently evaluating the impact, if any, that the adoption of this Statement will have on the Condensed Consolidated Financial Statements of the Company.

In June 2007, the EITF issued EITF Issue No. 06-11 "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards." This issue requires that the tax benefits related to dividend equivalents paid on restricted stock units, which are expected to vest, be recorded as an increase to additional paid-in capital. EITF 06-11 is effective prospectively to the income tax benefits on dividends declared in fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact, if any, the adoption of this issue may have on the Company's Condensed Consolidated Financial Statements and does not expect that the adoption of this issue will have a material impact on the Condensed Consolidated Financial Statements.

In December 2007, the American Securitization Forum published a Streamlined Foreclosure and Loss Avoidance Framework (ASF Framework) to enable mortgage servicers to streamline their loss avoidance and loan modification practices. The framework is an industry-developed, recommended methodology that servicers of securitized subprime ARMS held in QSPEs can use to fulfill their existing obligations to service those loans in a faster and more efficient manner while maximizing recoveries for the benefit of securitization investors. The ASF Framework applies to all first lien subprime residential ARMs that have an initial fixed rate period of 36 months or less that were originated between January 1, 2005 and July 31, 2007, and that have an initial interest rate reset between January 1, 2008 and July 31, 2010.

Under the ASF Framework, the covered loans are divided into three segments:

Segment 1 - includes current loans where the borrower is likely to be able to refinance into any available mortgage product, including FHA, FHA Secure or readily available mortgage industry products;

Segment 2 - includes current loans where the borrower is unlikely to be able to refinance into any readily available mortgage industry product; and

Segment 3 - includes loans where the borrower is not current as defined above, demonstrating difficulty meeting the introductory rate.

The methodology prescribed in the ASF Framework applies to those loans in Segment 2, in advance of the initial reset date. Those loans would be eligible for a "fast track" loan modification under which the interest rate would be kept at the existing rate, generally for five years following the upcoming reset. The ASF Framework provides a methodology which complies with relevant tax regulations and off-balance-sheet accounting standards for QSPEs. Moreover, the SEC's Office of Chief Accountant has concluded that it will not object to continued status as a QSPE if Segment 2 subprime ARM loans are modified pursuant to the specific screening criteria in the ASF Framework. The Company adopted the ASF screening criteria in the first quarter of 2008, and believes that the modification of loans in accordance with the ASF Framework does not impact the off-balance-sheet accounting treatment of QSPEs that hold subprime ARM loans.

While a uniform definition of subprime mortgages does not exist in the marketplace, the Company defines subprime primarily as loans issued to higher risk borrowers who do not qualify for the best market interest rates because of their deficient credit history. Although FICO credit scores and prior mortgage or rent payment histories are the main drivers of a subprime designation, subprime also includes borrowers that have had a recent foreclosure or bankruptcy. Other considerations include borrower's reserve funds, residual household income and debt to income ratio. The Company has not yet modified a significant percentage of loans using the ASF Framework; accordingly, the impact to the Company's retained interest has been immaterial.

2. FINANCIAL INSTRUMENTS

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

(in millions)	February 29, 2008	November 30, 2007
FINANCIAL INSTRUMENTS OWNED, AT FAIR VALUE:		
U.S. government and agency	$ 21,310	$ 12,920
Other sovereign governments	2,394	672
Corporate equity and convertible debt	26,975	32,454
Corporate debt and other	23,511	26,330

Mortgages, mortgage- and asset-backed	38,186	46,141
Derivative financial instruments	28,728	19,725
	$ 141,104	$ 138,242

FINANCIAL INSTRUMENTS SOLD, BUT NOT YET PURCHASED, AT FAIR VALUE:		
U.S. government and agency	$ 9,718	$ 4,563
Other sovereign governments	1,189	2,473
Corporate equity and convertible debt	18,700	18,843
Corporate debt and other	5,079	4,373
Mortgages, mortgage- and asset-backed	348	63
Derivative financial instruments	16,510	13,492
	$ 51,544	$ 43,807

As of February 29, 2008 and November 30, 2007, all financial instruments owned that were pledged to counterparties where the counterparty has the right, by contract or custom, to rehypothecate those securities are classified as "Financial instruments owned and pledged as collateral, at fair value" in the Condensed Consolidated Statements of Financial Condition.

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

Concentration Risk

The Company is subject to concentration risk by holding large positions or committing to hold large positions in certain types of securities, securities of a single issuer (including governments), issuers located in a particular country or geographic area, or issuers engaged in a particular industry. Positions taken and commitments made by the Company, including underwritings, often involve substantial amounts and significant exposure to individual issuers and businesses, including non-investment-grade issuers. At February 29, 2008 and November 30, 2007, the Company's most significant concentrations were related to United States government securities, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation agency-backed securities, which are included in the U.S. government and agency and Mortgages, mortgage-and asset-backed inventory captions above. In addition, a substantial portion of the collateral held by the Company for reverse repurchase agreements consists of securities issued by the U.S. government and agencies.

Fair Value Measurements

The Company follows SFAS No. 157, "Fair Value Measurements." SFAS No. 157 applies to all financial instruments that are measured and reported on a fair value basis. This includes those items currently reported in "Financial instruments owned, at fair value" and "Financial instruments sold, but not yet purchased, at fair value" on

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the Condensed Consolidated Statements of Financial Condition as well as financial instruments reported in "Other assets" and "Other liabilities" captions that are reported at fair value below.

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

Level 1: Quoted market prices in active markets for identical assets or liabilities.
Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.
Level 3: Unobservable inputs that are not corroborated by market data.

Level 1 primarily consists of financial instruments whose value is based on quoted market prices such as exchange-traded derivatives and listed equities. This category also includes financial instruments that are valued using alternative approaches but for which the Company typically receives independent external valuation information including U.S. Treasuries, other U.S. Government and agency securities, and certain cash instruments such as money market funds and certificates of deposit.

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

Level 3 is comprised of financial instruments whose fair value is estimated based on internally developed models or methodologies utilizing significant inputs that are generally less readily observable. Included in this category are distressed debt, non-performing mortgage-related assets, certain performing residential and commercial mortgage loans, certain mortgage- and asset-backed securities and residual interests, Chapter 13

and other credit card receivables from individuals, and complex derivative structures including long-dated equity derivatives.

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

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Fair Value Measurements on a Recurring Basis as of February 29, 2008:

(in millions)	Level 1	Level 2	Level
Financial Instruments Owned, at fair value			
U.S. government and agency	$ 5,857	$ 15,453	$ -
Other sovereign governments	--	2,394	-
Corporate equity and convertible debt	19,798	6,830	
Corporate debt and other	14	18,373	5,
Mortgages, mortgage- and asset-backed	--	15,966	22,
Total Non Derivative Trading Assets	25,669	59,016	27,
Derivative financial instruments (1)	202	272,356	6,
Total Financial Instruments Owned, at fair value	25,871	331,372	33,
Other Assets(2)	391	1,607	3,
Total Assets at fair value	$ 26,262	$ 332,979	$ 37,

(in millions)	Level 1	Level 2	Level
Financial Instruments Sold But Not Yet Purchased, at fair value			
U.S. government and agency	$ (9,718)	$ --	$ -

Other sovereign governments	--	(1,189)	-
Corporate equity and convertible debt	(16,554)	(2,145)	
Corporate debt and other	--	(5,053)	
Mortgages, mortgage- and asset-backed	--	(348)	-
Total Non Derivative Trading Liabilities	(26,272)	(8,735)	
Derivative financial instruments (1)	(185)	(254,426)	(5,
Total Financial Instruments Sold But Not Yet Purchased, at fair value	(26,457)	(263,161)	(5,
Other Liabilities(3)	(82)	(7,715)	(1,
Total Liabilities at fair value	$ (26,539)	$ (270,876)	$ (6,

(1) The derivatives trading inventory balances are reported on a gross basis by level with a corresponding adjustment for netting.

(2) Other assets includes certain items such as alternative investments, mortgage servicing rights, net assets of variable interest entities and mortgage securitizations that did not meet the criteria for sale treatment under SFAS No. 140.

(3) Other liabilities are primarily comprised of certain hybrid debt issuances accounted for at fair value as elected in accordance with SFAS No. 155.

As stated above SFAS No. 157 applies to all financial assets and liabilities that are reported on a fair value basis. These valuations are adjusted for various factors including credit risk. For applicable financial assets carried at fair value, the credit standing of the counterparties is analyzed and factored into the fair value measurement of those assets. SFAS No. 157 states that the fair value measurement of a liability must reflect the nonperformance risk of the entity. Therefore, the impact of credit standing as well as any potential credit enhancements (e.g. collateral) has been factored into the fair value measurement of both financial assets and liabilities.

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

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netting agreement. The fair value of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy.

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

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

Level 3 Financial Assets and Liabilities
Three months ended February 29, 2008

(in millions)	Beginning Balance as of December 1, 2007	Total Gains/ (Losses) (Realized and Unrealized)	Purchases, Issuances, Sales and Settlements	Transfer In/Out o Level 3
Non-Derivative Trading Assets	$ 22,080	$ (1,435)	$ 118	$ 6,
Non Derivative Trading Liabilities	$ (58)	$ (6)	$ 23	$
Derivative Trading Inventory (Net)	$ (589)	$ 763	$ 290	$
Other Assets	$ 3,758	$ (369)	$ (165)	$
Other Liabilities	$ (1,254)	$ 142	$ (47)	$ (

Non-Derivative Trading Assets and Liabilities

Realized and unrealized gains and losses on Level 3 assets and liabilities are primarily reported in "Principal transactions" revenues in the Condensed Consolidated Statements of Income. The Level 3 non-derivative trading assets reflect an unrealized loss related to the mortgage related inventory write-downs incurred during the first quarter of 2008. The Company manages its exposure on a portfolio basis and regularly engages in offsetting strategies in which financial instruments from one fair value hierarchy level are used to economically offset the risk of financial instruments in the same or different levels. Therefore, realized and unrealized gains and losses reported as Level 3 may be offset by gains or losses attributable to assets or liabilities classified in Level 1 or Level 2.

Derivative Trading Inventory (Net)

The net derivative trading inventory resulted in a gain for the first quarter of 2008. This gain was primarily driven by changes in interest rates and credit spreads related to the Company's interest rate and credit derivative products.

Transfers

The Company reviews the fair value hierarchy classifications on a monthly basis. Changes in the observability of the valuation attributes may result in a reclassification of certain financial assets or liabilities. Such reclassifications are reported as transfers in/out of Level 3 at fair value in the month in which the changes occur.

During the 2008 quarter, there were approximately $6.9 billion of non-derivative trading assets transferred from level 2 to level 3. These transfers were primarily related to mortgages and mortgage-backed securities. The largest

contributors to the transfers were performing residential mortgages and investment-grade mortgage-backed securities. Additionally, during the 2008 quarter, there were approximately $700 million of net derivative trading assets which transferred from level 2 to level 3. These transfers were primarily related to mortgage-related credit default swaps.

These transfers were driven by the continued market and liquidity deterioration in the mortgage markets.

Fair Value Option

SFAS No. 159 provides a fair value option election that permits entities to irrevocably elect to measure financial assets and liabilities (except for those that are specifically scoped out of the Statement) at fair value as the initial and subsequent measurement attribute, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument.

Effective December 1, 2007, the Company adopted SFAS No. 159 and elected to apply the fair value option to liabilities of variable interest entities and mortgage loan special purpose entities. Incorporated in the SFAS No. 159 guidance are specific disclosure requirements related to the hybrid financial instruments elected under SFAS No. 155.

In accordance with SFAS No. 155, the Company measures certain hybrid financial instruments at fair value. These hybrid financial instruments are recorded in "Long-term borrowings" and "Unsecured short-term borrowings" in the Condensed Consolidated Statements of Financial Condition. Changes in the fair value of these hybrid financial instruments, including interest, are reflected in "Principal transactions" revenues in the Condensed Consolidated Statements of Income. Gains

(losses) related to changes in the fair value of these hybrid financial instruments classified as Long term borrowings amounted to $639 million and $337 million for the three months ended February 29, 2008 and February 28, 2007 respectively, of which $305 million and $35 million were attributable to the widening of the Company's credit spreads and were derived from the Company's bond market spreads during the respective periods. Gains (losses) related to changes in the fair value of these hybrid financial instruments classified as Unsecured short-term borrowings were not material for the three months ended February 29, 2008 and February 28, 2007. As of February 29, 2008 and November 30, 2007, the aggregate principal balance classified as Long term borrowings, exceeded the aggregate fair value by $1.8 billion and $547 million, respectively. As of February 29, 2008 and November 30, 2007, the aggregate principal balance classified as Unsecured short-term borrowings, exceeded the aggregate fair value by approximately $224 million and $203 million, respectively. As a result of the events described in Note 17, "Subsequent Events" of Notes to the Condensed Consolidated Financial Statements, approximately $372 million in losses were recognized during the month ended March 31, 2008, due to tightening of the Company's credit spreads.

3. DERIVATIVES AND HEDGING ACTIVITIES

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

instruments sold, but not yet purchased may result in market and/or credit risk in excess of amounts recorded in the Condensed Consolidated Statements of Financial Condition.

Market Risk

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

Derivatives Credit Risk

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

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

Hedging Activity

To modify the interest rate characteristics of its long- and short-term debt, the Company also engages in non-trading derivatives activities. The Company has issued U.S. dollar- and foreign currency-denominated debt with both variable- and fixed-rate interest payment obligations. The Company has entered into interest rate swaps, primarily based on LIBOR, to convert fixed-rate interest payments on its debt obligations into variable-rate payments. In addition, for foreign currency debt obligations that are not used to fund assets in the same currency, the Company has entered into currency swap agreements that effectively convert the debt into U.S. dollar obligations. Such transactions are accounted for as fair value hedges.

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

SFAS No. 133, as amended by SFAS No. 138 and SFAS No. 149, establishes

accounting and reporting standards for stand-alone derivative instruments, derivatives embedded within other contracts or securities and for hedging activities. It requires that all derivatives, whether standalone or embedded within other contracts or securities be carried on the Company's Condensed Consolidated Statements of Financial Condition at fair value. SFAS No. 133 also requires the value of items designated as being fair value hedged to be adjusted for the risk being hedged, as defined in SFAS No. 133, provided that the intent to hedge is fully documented. Any resultant net change in value for both the hedging derivative and the hedged item for the risk being hedged is recognized in earnings immediately,

such net effect being deemed the "ineffective" portion of the hedge. The gains and losses associated with the ineffective portion of the fair value hedges are included in "Principal transactions" revenues in the Condensed Consolidated Statements of Income. These amounts were immaterial for the three months ended February 29, 2008.

The Company also engages in non-trading derivative activities to manage commodity price risks resulting from exposures to changes in spot and forward prices in electricity and natural gas. The Company actively manages these risks with exchange traded futures, swaps, OTC swaps and options. Certain of these transactions are accounted for as cash flow hedges as defined in SFAS No. 133 which requires the effective portion of the unrealized gain or loss on a derivative designated as a cash flow hedge, as defined in SFAS No. 133, to be reported in "Accumulated other comprehensive income" ("OCI") with the ineffective portion reported in "Principal transactions" revenues in the Condensed Consolidated Statements of Income. Amounts that are reported in OCI are reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of cash flow hedges was deemed immaterial for the three months ended February 29, 2008.

The net gain on derivative instruments designated in cash flow hedging relationships recorded in OCI, net of tax, was $25 million at February 29, 2008. The net increase in fair value recorded in OCI in the first quarter of 2008 was $35 million. The net gain in OCI is expected to be reclassified into earnings as follows: $6 million in fiscal 2008 and the remaining $19 million of gains within five years.

4. TRANSFERS OF FINANCIAL ASSETS AND LIABILITIES

Securitizations

The Company is a market leader in mortgage-backed securitization and other structured financing arrangements. In the normal course of business, the Company regularly securitizes commercial and residential mortgages, consumer receivables and other financial assets. Securitization transactions are generally treated as sales, provided that control has been relinquished. In connection with securitization transactions, the Company establishes special-purpose entities ("SPEs"), in which transferred assets, including commercial and residential mortgages,

consumer receivables and other financial assets are sold to an SPE and repackaged into securities or similar beneficial interests. Transferred assets are accounted for at fair value prior to securitization. The majority of the Company's involvement with SPEs relates to securitization transactions meeting the definition of a QSPE under the provisions of SFAS No. 140. Provided it has relinquished control over such assets, the Company derecognizes financial assets transferred in securitizations and does not consolidate the financial statements of QSPEs. For SPEs that do not meet the QSPE criteria, the Company uses the guidance in FIN No. 46 (R) to determine whether the SPE should be consolidated.

In connection with these securitization activities, the Company may retain interests in securitized assets in the form of senior or subordinated securities or as residual interests. Retained interests in securitizations are generally not held to maturity and typically are sold shortly after the settlement of a securitization. The weighted average holding period for retained interest positions in inventory at February 29, 2008 and November 30, 2007 was approximately 210 days and 180 days, respectively. These retained interests are included in "Financial instruments owned, at fair value" in the Condensed Consolidated Statements of Financial Condition and are carried at fair value. Consistent with the valuation of similar inventory, fair value is determined by broker-dealer price quotations and internal valuation pricing models that utilize variables such as yield curves, prepayment speeds, default rates, loss severity, interest rate volatilities and spreads. The assumptions used for pricing variables are based on observable transactions in similar securities and are further verified by external pricing sources, when available.

The Company's securitization activities are detailed below:

(in billions)	Agency Mortgage-Backed	Other Mortgage- and Asset-Backed
Total securitizations		
Three months ended February 29, 2008	$5.4	$3.9
Three months ended February 28, 2007	$4.7	$21.3

The following table summarizes the Company's retained interests by rating as of February 29, 2008 and November 30, 2007:

(in billions)	February 29, 2008	November 30, 2007
Retained Interests:		
AAA rated Agency Mortgage-Backed	$2.6	$2.4

AAA rated Other Mortgage and Asset-Backed	2.9	2.7
Total AAA rated	$5.5	$5.1
Other investment grade	1.4	1.6
Non-investment grade	1.3	1.3
Total retained interests	$8.2	$8.0

The following table summarizes cash flows from securitization trusts related to securitization transactions during the three months ended February 29, 2008 and February 28, 2007:

(in millions)	Agency Mortgage-Backed	Other Mortgage- and Asset-Backed	Total
Cash flows received from retained interests			
Three months ended February 29, 2008	$10.1	$1.2	$11.3
Three months ended February 28, 2007	$13.5	$78.3	$91.8
Cash flows from servicing			
Three months ended February 29, 2008	$ -	$5.1	$5.1
Three months ended February 28, 2007	$ -	$4.5	$4.5

The Company is an active market maker in mortgage-backed securities and therefore may retain interests in assets it securitizes, predominantly highly rated or government agency-backed securities. The models employed in the valuation of retained interests consider possible changes in prepayment speeds in response to changes in future interest rates, as well as potential credit losses. Prepayment speed changes are incorporated by calibrating the distribution of possible future interest rates to the observed levels of implied volatility in the market for interest rate options and generating the corresponding cash flows for the securities using prepayment models. Credit losses are considered through explicit loss models for positions exposed to significant default risk in the underlying collateral, and through option-adjusted spreads that also incorporate additional factors such as liquidity and model uncertainty for all positions. The models use discount rates that are based on the Treasury curve, plus the option-adjusted spread. Key points on the constant maturity Treasury curve at February 29, 2008 were 1.63% for 2-year Treasuries and 3.78% for 10-year Treasuries, and ranged from 1.57% to 4.44%. The weighted average spread was 207 basis points and 561 basis points for agency mortgage-backed securities and other mortgage- and asset-backed securities, respectively, at February 29, 2008.

Weighted key economic assumptions used in measuring the fair value of retained interests in assets the Company securitized at February 29, 2008 were as follows:

	Agency Mortgage-Backed	Other Mortgage- and Asset-Backed
Weighted average life (years)	5.9	3.1
Average prepayment speeds (annual rate)	8% - 36%	8% - 40%
Credit losses	-	0.9% - 53%

The following hypothetical sensitivity analysis as of February 29, 2008 illustrates the potential adverse change in fair value of these retained interests due to a specified change in the key valuation assumptions. The interest rate changes represent a parallel shift in the Treasury curve. This shift considers the corresponding effect of other variables, including prepayments. The remaining valuation assumptions are changed independently. Retained interests in securitizations are generally not held to maturity and are typically sold shortly after the settlement of a securitization. The Company considers the current and expected credit profile of the underlying collateral in determining the fair value and periodically updates the fair value for changes in credit, interest rate, prepayment speeds and other pertinent market factors. Changes in portfolio composition, updates to loss and prepayment models, and changes in the level of interest rates and market prices for retained interests, can combine to produce significant changes in the sensitivities reported even if aggregate market values do not change significantly. Actual credit losses on retained interests have not been significant.

(in millions)	Agency Mortgage-Backed	Other Mortgage- and Asset-Backed
Interest rates		
Impact of 50 basis point adverse change	$ (78)	(113)
Impact of 100 basis point adverse change	(167)	(232)
Prepayment speeds		
Impact of 10% adverse change	(5)	(33)
Impact of 20% adverse change	(10)	(58)
Credit losses		
Impact of 10% adverse change	(18)	(161)
Impact of 20% adverse change	(36)	(294)

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

Mortgage Servicing Rights

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

The Company follows SFAS No. 156 and carries its MSRs at fair value, with changes in fair value reported in earnings.

The determination of fair value of the Company's MSRs requires management judgment because they are not actively traded. The determination of fair value for MSRs requires valuation processes which combine the use of discounted cash flow models and extensive analysis of current market data to arrive at an estimate of fair value. The cash flow and prepayment assumptions used in the Company's discounted cash flow model are based on empirical data drawn from the historical performance of the Company's MSRs adjusted to reflect current Market conditions, which the Company believes are consistent with assumptions used by market participants valuing similar MSRs. The key risks and therefore the key assumptions used in the valuation of MSRs include mortgage prepayment speeds and the discount rates. These variables can, and generally will, change from quarter to quarter as market conditions and projected interest rates change. The Company mitigates the income statement effect of changes in fair value of MSRs by entering into economic offsetting transactions.

At February 29, 2008, the key economic assumptions and the sensitivity of the current fair value of MSRs to immediate changes in those assumptions were as follows:

(in millions)	February 29, 2008
Fair value of MSRs	$ 771
Weighted average constant prepayment rate (CPR)	10.7%
Impact on fair value of:	
10% adverse change	$ (30)
20% adverse change	(51)
Weighted average discount rate	13.3%
Impact on fair value of:	
10% adverse change	$ (24)
20% adverse change	(46)
Weighted average constant default rate (CDR)	7.7%
Impact on fair value of:	
10% adverse change	$ (25)
20% adverse change	(48)

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

MSRs are included in "Other assets" on the Condensed Consolidated Statements of Financial Condition and are carried at fair value in accordance with SFAS No. 156. The Company's MSRs activities for the three months ended February 29, 2008 and February 28, 2007 were as follows:

(in millions)	February 29, 2008	February 28, 2007
Balance, beginning of period	$ 833	$ 502
Additions	2	112
Paydowns	(23)	(39)
Changes in fair value resulting from changes in valuation inputs/assumptions	(41)	5
Balance, end of period	$ 771	$ 580

5. VARIABLE INTEREST ENTITIES AND MORTGAGE LOAN SPECIAL PURPOSE ENTITIES

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

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

the VIE.

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

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

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

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

The following table sets forth the Company's total assets and maximum exposure to loss associated with its significant variable interests in consolidated VIEs and securitizations that did not qua