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BEAR STEARNS COMPANIES INC

Form 10-Q

October 10, 2006

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

FORM 10-Q

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

For the quarterly period ended August 31, 2006

or

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

For the transition period from _____ to _____

Commission file number 1-8989

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

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

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

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

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

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

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

As of October 6, 2006, the latest practicable date, there were 117,311,064
shares of Common Stock, \$1 par value, outstanding.

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AVAILABLE INFORMATION

The Bear Stearns Companies Inc. and its subsidiaries ("Company") files current, annual and quarterly reports, proxy statements and other information required by the Securities Exchange Act of 1934, as amended ("Exchange Act"), with the Securities and Exchange Commission ("SEC"). You may read and copy any document the Company files at the SEC's public reference room located at 100 F Street, NE, Room 1580, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. The Company's SEC filings are

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also available to the public from the SEC's internet site at <http://www.sec.gov>. Copies of these reports, proxy statements and other information can also be inspected at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005.

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

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

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

THE BEAR STEARNS COMPANIES INC.

Condensed Consolidated Statements of Income

| | (Unaudited) Three Months Ended | | (Unaudited) Nine Months |
|---|-----------------------------------|--------------------|----------------------------|
| (in thousands, except share and per share data) | August 31, 2006 | August 31, 2005 | August 31, 2006 |
| <hr/> | | | |
| REVENUES | | | |
| Commissions | \$ 280,033 | \$ 290,799 | \$ 871,355 |
| Principal transactions | 1,093,997 | 883,142 | 3,736,907 |
| Investment banking | 283,507 | 315,897 | 939,510 |
| Interest and dividends | 2,322,992 | 1,344,089 | 6,157,857 |
| Asset management and other income | 155,158 | 91,467 | 372,225 |
| | 4,135,687 | 2,925,394 | 12,077,854 |
| Interest expense | 2,006,552 | 1,113,114 | 5,264,074 |
| | 2,129,135 | 1,812,280 | 6,813,780 |
| | Revenues, net of interest expense | | |

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NON-INTEREST EXPENSES

| | | | |
|--|-------------|-------------|--------------|
| Employee compensation and benefits | 1,024,748 | 850,985 | 3,291,814 |
| Floor brokerage, exchange and clearance fees | 58,621 | 55,029 | 168,485 |
| Communications and technology | 126,938 | 97,668 | 349,141 |
| Occupancy | 52,976 | 43,354 | 143,025 |
| Advertising and market development | 38,243 | 32,784 | 108,009 |
| Professional fees | 78,110 | 60,018 | 197,451 |
| Other expenses | 82,261 | 92,287 | 302,065 |
| | ----- | ----- | ----- |
| Total non-interest expenses | 1,461,897 | 1,232,125 | 4,559,990 |
| | ----- | ----- | ----- |
| Income before provision for income taxes | 667,238 | 580,155 | 2,253,790 |
| Provision for income taxes | 229,682 | 201,850 | 762,745 |
| | ----- | ----- | ----- |
| Net income | \$ 437,556 | \$ 378,305 | \$ 1,491,045 |
| | ===== | ===== | ===== |
| Net income applicable to common shares | \$ 432,240 | \$ 372,357 | \$ 1,474,939 |
| | ===== | ===== | ===== |
| Basic earnings per share | \$ 3.34 | \$ 2.96 | \$ 11.38 |
| Diluted earnings per share | \$ 3.02 | \$ 2.69 | \$ 10.28 |
| | ===== | ===== | ===== |
| Weighted average common shares outstanding: | | | |
| Basic | 132,086,016 | 130,194,452 | 132,539,603 |
| Diluted | 148,899,406 | 147,051,538 | 149,484,747 |
| | ===== | ===== | ===== |
| Cash dividends declared per common share | \$ 0.28 | \$ 0.25 | \$ 0.84 |
| | ===== | ===== | ===== |

See Notes to Condensed Consolidated Financial Statements.

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THE BEAR STEARNS COMPANIES INC.

Condensed Consolidated Statements of
Financial Condition

(in thousands, except share data)

(Unaudited)
August 31,
2006

ASSETS

| | |
|--|--------------|
| Cash and cash equivalents | \$ 4,725,977 |
| Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations | 8,845,358 |
| Securities purchased under agreements to resell | 40,457,197 |
| Securities received as collateral | 17,480,124 |
| Securities borrowed | 73,959,757 |
| Receivables: | |
| Customers | 29,969,736 |
| Brokers, dealers and others | 5,614,021 |
| Interest and dividends | 649,728 |

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| | |
|---|----------------|
| Financial instruments owned, at fair value | 111,895,526 |
| Financial instruments owned and pledged as collateral, at fair value | 10,890,739 |
| | ----- |
| Total financial instruments owned, at fair value | 122,786,265 |
| Assets of variable interest entities and mortgage loan special purpose entities | 25,075,409 |
| Property, equipment and leasehold improvements, net of accumulated depreciation and amortization of \$1,115,098 and \$1,011,036 as of August 31, 2006 and November 30, 2005, respectively | 483,064 |
| Other assets | 4,713,684 |
| | ----- |
| Total Assets | \$ 334,760,320 |
| | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| Short-term borrowings | \$ 25,781,755 |
| Securities sold under agreements to repurchase | 66,873,544 |
| Obligation to return securities received as collateral | 17,480,124 |
| Securities loaned | 10,127,250 |
| Payables: | |
| Customers | 80,628,490 |
| Brokers, dealers and others | 1,619,331 |
| Interest and dividends | 1,026,527 |
| Financial instruments sold, but not yet purchased, at fair value | 41,058,913 |
| Liabilities of variable interest entities and mortgage loan special purpose entities | 24,199,703 |
| Accrued employee compensation and benefits | 2,331,573 |
| Other liabilities and accrued expenses | 1,709,765 |
| Long-term borrowings | 50,201,398 |
| | ----- |
| Total Liabilities | 323,038,373 |
| | ----- |
| Commitments and contingencies (Note 10) | |
| STOCKHOLDERS' EQUITY | |
| Preferred stock | 359,156 |
| Common stock, \$1.00 par value; 500,000,000 shares authorized and 184,805,847 shares issued as of both August 31, 2006 and November 30, 2005 | 184,806 |
| Paid-in capital | 4,511,041 |
| Retained earnings | 8,861,718 |
| Employee stock compensation plans | 2,095,820 |
| Unearned compensation | (146,463) |
| Treasury stock, at cost: | |
| Common stock: 66,254,688 and 70,937,640 shares as of August 31, 2006 and November 30, 2005, respectively | (4,144,131) |
| | ----- |
| Total Stockholders' Equity | 11,721,947 |
| | ----- |
| Total Liabilities and Stockholders' Equity | \$ 334,760,320 |
| | ===== |

See Notes to Condensed Consolidated Financial Statements.

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Cash Flows

| (in thousands) | (Unaudited) Nine Months Ended | |
|--|----------------------------------|----------------|
| | August 31, 2006 | August 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$ 1,491,045 | \$ 1,055,000 |
| Adjustments to reconcile net income to cash used in operating activities: | | |
| Non-cash items included in net income: | | |
| Depreciation and amortization | 265,040 | 196,000 |
| Deferred income taxes | (6,184) | (66,000) |
| Employee stock compensation plans | 15,211 | 48,000 |
| Changes in operating assets and liabilities: | | |
| Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations | (3,575,682) | (1,284,000) |
| Securities borrowed, net of securities loaned | (11,021,822) | 7,003,000 |
| Net receivables from customers | 10,682,667 | (7,908,000) |
| Net receivables from brokers, dealers and others | (3,107,062) | (2,181,000) |
| Financial instruments owned | (15,889,956) | (21,449,000) |
| Other assets | (447,228) | (690,000) |
| Securities sold under agreements to repurchase, net of securities purchased under agreements to resell | 2,932,333 | 8,078,000 |
| Financial instruments sold, but not yet purchased | 5,549,652 | 3,098,000 |
| Accrued employee compensation and benefits | 466,265 | 200,000 |
| Other liabilities and accrued expenses | 127,438 | 885,000 |
| Cash used in operating activities | (12,518,283) | (13,012,000) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of property, equipment and leasehold improvements | (144,081) | (152,000) |
| Cash used in investing activities | (144,081) | (152,000) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net proceeds from short-term borrowings | 5,766,028 | 6,242,000 |
| Proceeds from issuance of long-term borrowings | 13,396,397 | 11,666,000 |
| Payments for retirement/repurchase of long-term borrowings | (7,574,980) | (5,781,000) |
| Proceeds from issuances of derivatives with a financing element, net | 504,928 | 158,000 |
| Issuance of common stock | 228,326 | 158,000 |
| Cash retained resulting from tax deductibility under share-based payment arrangements | 321,432 | 320,000 |
| Redemption of preferred stock | (13,116) | (75,000) |
| Treasury stock purchases - common stock | (982,695) | (505,000) |
| Cash dividends paid | (117,112) | (105,000) |
| Cash provided by financing activities | 11,529,208 | 12,078,000 |
| Net decrease in cash and cash equivalents | (1,133,156) | (1,086,000) |
| Cash and cash equivalents, beginning of year | 5,859,133 | 4,173,000 |
| Cash and cash equivalents, end of period | \$ 4,725,977 | \$ 3,086,000 |

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Supplemental Disclosure of Cash Flow Information:

Cash payments for interest were \$5.61 billion and \$2.86 billion during the nine months ended August 31, 2006 and 2005, respectively.

Cash payments for income taxes, net of refunds, were \$592.4 million and \$112.7 million for the nine months ended August 31, 2006 and 2005, respectively.

Cash payments for income taxes, net of refunds, would have been \$913.8 million and \$433.4 million for the nine months ended August 31, 2006 and 2005, respectively, 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.

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

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

The Bear Stearns Companies Inc. (the "Company") is a holding company that, through its broker-dealer and international bank subsidiaries, principally Bear, Stearns & Co. Inc. ("Bear Stearns"), Bear, Stearns Securities Corp. ("BSSC"), Bear, Stearns International Limited ("BSIL") and Bear Stearns Bank plc ("BSB"), is primarily engaged in business as a securities broker-dealer and operates in three principal segments: Capital Markets, Global Clearing Services and Wealth Management. Capital Markets comprises 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 comprises the private client services ("PCS") and asset management areas. See Note 12, "Segment Data," in the Notes to Condensed Consolidated Financial Statements. The Company also conducts significant activities through other wholly owned subsidiaries, including: Bear Stearns Global Lending Limited; Custodial Trust Company; Bear Stearns Financial Products Inc.; Bear Stearns Capital Markets Inc.; Bear Stearns Credit Products Inc.; Bear Stearns Forex Inc.; EMC Mortgage Corporation; and Bear Stearns Commercial Mortgage, Inc. and through its majority-owned subsidiary Bear Hunter Holdings LLC. As used in this report, the "Company" refers (unless the context requires otherwise) to The Bear Stearns Companies Inc. and its subsidiaries.

Basis of Presentation

The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling interest. In accordance with Financial Accounting Standards Board ("FASB") Interpretation ("FIN") No. 46 (R), "Consolidation of Variable Interest Entities" ("FIN No. 46 (R)"), the Company also consolidates any variable interest entities ("VIEs") for which it is the primary beneficiary. The assets and related liabilities of

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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.

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

The Condensed Consolidated Statement of Financial Condition as of August 31, 2006, the Condensed Consolidated Statements of Income for the three and nine months ended August 31, 2006 and August 31, 2005 and the Condensed Consolidated Statements of Cash Flows for the nine months ended August 31, 2006 and August 31, 2005 are unaudited. The Condensed Consolidated Statement of Financial Condition at November 30, 2005 and related information was derived from the audited consolidated financial statements.

The condensed consolidated financial statements are prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") with respect to the Form 10-Q and reflect all adjustments which, in the opinion of management, are normal and recurring, and which are necessary for a fair statement of the results for the interim periods presented. In accordance with such rules and regulations, certain disclosures that are normally included in annual financial statements have been omitted. These financial statements should be read together with the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2005, as amended by Amendment No. 1 thereto on Form 10-K/A, each as filed by the Company under the Securities Exchange Act of 1934, as amended ("Exchange Act") (together, the "Form 10-K").

The condensed consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. These principles require management to make certain estimates and assumptions, including those regarding inventory valuations, stock-based compensation, certain accrued liabilities

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

and the potential outcome of litigation and tax matters, which may affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ materially from these estimates. The nature of the Company's business is such that the results of any interim period may not be indicative of the results to be expected for an entire fiscal year. All material intercompany transactions and balances have been eliminated in consolidation. Certain prior period amounts have been reclassified to conform to the current period's presentation.

Financial Instruments

Proprietary securities, futures and other derivative transactions are recorded on a trade date basis. Financial instruments owned and financial

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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.

Fair value is generally based on quoted market prices. If quoted market prices are not available, or if liquidating the Company's position is reasonably expected to affect market prices, 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.

The Company follows Emerging Issues Task Force ("EITF") Statement No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities." This guidance prohibits recognizing profit at the inception of a derivative contract unless the fair value of the derivative is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique that incorporates observable market data.

Equity interests and securities acquired as a result of private equity and merchant banking activities are reflected in the condensed consolidated financial statements at their fair value. Fair value is generally defined as an investment's initial cost until significant transactions or developments indicate that a change in the carrying value of the investment is appropriate. Generally, the carrying values of these securities will be increased in those instances where market values are readily ascertainable by reference to substantial transactions occurring in the marketplace or quoted market prices. Reductions to the carrying value of these securities are made when the Company's estimate of net realizable value has declined below the carrying value.

Derivative Instruments and Hedging Activities

The Company follows Statement of Financial Accounting Standards ("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 (except in narrowly defined circumstances), are carried in the Company's Condensed Consolidated Statements of Financial Condition at fair value, with changes in fair value recorded in current earnings in "Principal transactions" revenues. Designated hedged items in fair value hedging relationships are marked for the risk being hedged, with such changes recorded in current earnings.

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

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

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

Mortgage Servicing Assets, Fees and Advances

Mortgage servicing rights ("MSRs"), which are included in "Other assets" on the Condensed Consolidated Statements of Financial Condition, are reported at the lower of amortized cost or market. MSRs are amortized in proportion to and over the period of estimated net servicing income. MSRs are periodically evaluated for impairment based on the fair value of those rights determined by using market-based models that discount anticipated future net cash flows considering loan prepayment estimates, interest rates, default rates, servicing costs and other economic factors. For purposes of impairment evaluation and measurement, the Company stratifies MSRs by predominant risk characteristics. The excess of amortized cost over market value is reflected as a valuation allowance at balance sheet dates.

Contractual servicing fees, late fees and other ancillary servicing fees earned for servicing mortgage loans are reflected net of MSR amortization and impairment/recovery 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.

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

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

Collateralized Securities Transactions

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

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

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.

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.

Asset Management and Other Income

The Company receives advisory fees for investment management. Advisory fees are recognized over the period that the related service is provided based upon the net asset value. Unearned advisory fees are treated as deferred revenues and are included in "Other liabilities" in the accompanying Condensed Consolidated Statements of Financial Condition. In addition, the Company receives performance incentive fees for managing certain funds based upon the achievement of specified performance targets. These fees are accrued as earned during the period when the assets under management exceed the applicable specific investment performance target.

Fixed Assets

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

Goodwill and Identifiable Intangible Assets

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

Earnings Per Share

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

Effective December 1, 2002, the Company elected to adopt fair value accounting for stock-based compensation consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," using the prospective method with guidance provided by SFAS No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure." As a result, commencing with options granted after November 30, 2002, the Company expenses the fair value of stock

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

options issued to employees over the related vesting period. Prior to December 1, 2002, the Company had elected to account for its stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), as permitted by SFAS No. 123. Under the provisions of APB No. 25, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's common stock at the date of grant over the amount an employee must pay to acquire the stock. Accordingly, no compensation expense had been recognized for stock option awards granted prior to December 1, 2002 because the exercise price was at the fair market value of the Company's common stock on the grant date.

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The cost related to stock-based compensation included in the determination of net income for the three and nine months ended August 31, 2006 has been fully determined under the fair value-based method, and for the three and nine months ended August 31, 2005 is less than that which would have been recognized if the fair value-based method had been applied to stock option awards since the original effective date of SFAS No. 123.

The following table illustrates the effect on net income and earnings per share for the three and nine months ended August 31, 2005 if the fair value-based method under SFAS No. 123 had been applied to stock options granted for the year ended November 30, 2002.

| | Three Months ended | Nine Months ended |
|--|-----------------------|----------------------|
| (in millions, except per share amounts) | August 31, 2005 | August 31, 2005 |
| Net income, as reported | \$ 378.3 | \$ 1,055.2 |
| Add: | | |
| Stock-based employee compensation plans expense included in reported net income, net of related tax effects | 7.2 | 27.9 |
| Deduct: | | |
| Total stock-based employee compensation plans expense determined under the fair value based method, net of related tax effects | (10.7) | (38.4) |
| Pro forma net income | \$ 374.8 | \$ 1,044.7 |
| | ===== | ===== |
| Earnings per share: | | |
| Basic - as reported | \$ 2.96 | \$ 8.22 |
| Basic - pro forma | \$ 2.94 | \$ 8.14 |
| Diluted - as reported | \$ 2.69 | \$ 7.42 |
| Diluted - pro forma | \$ 2.66 | \$ 7.35 |
| | ===== | ===== |

In December 2004, the FASB issued SFAS No. 123 (R), "Share-Based Payment." SFAS No. 123 (R) is a revision of SFAS No. 123 and supersedes APB No. 25 and amends SFAS No. 95, "Statement of Cash Flows." SFAS No. 123 (R) eliminates 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. The Company adopted SFAS No. 123 (R), as required, on December 1, 2005, using the modified prospective method with no material impact on the consolidated financial statements of the Company.

The Company has various employee stock compensation plans designed to increase the emphasis on stock-based incentive compensation and align the compensation of its key employees with the long-term interests of

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stockholders. Such plans provide for annual grants of stock units and stock options. The Company intends to offset the potentially dilutive impact of the annual grants by purchasing common stock throughout the year in open market and private transactions.

Cash Equivalents

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

Income Taxes

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

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 resulting from foreign currency transactions are included in net income.

Accounting and Reporting Developments

In June 2005, the EITF reached a consensus on 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. This guidance became effective upon ratification by the FASB on June 29, 2005 for all newly formed limited partnerships and for existing limited partnerships for which the partnership agreements have been modified. For all other limited partnerships, the guidance is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005. For newly formed and modified limited partnerships, the adoption of the EITF did not have a material impact on the consolidated financial statements of the Company. For previously existing limited partnerships, the Company does not expect the EITF consensus to have a material impact on the consolidated financial statements of the Company.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments." SFAS No. 155 is an amendment of SFAS No. 133 and SFAS No. 140. SFAS No. 155 permits companies to irrevocably elect, on a deal by deal basis, to apply a fair value remeasurement to any hybrid

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financial instruments that contain an embedded derivative that would otherwise require bifurcation. SFAS No. 155 is effective for the Company on December 1, 2006. The Company does not expect the adoption of SFAS No. 155 to have a material impact on the consolidated financial statements of the Company.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets." SFAS No. 156 amends SFAS No. 140. SFAS No. 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value. For subsequent measurements, SFAS No. 156 permits companies to choose between using an amortization method or a fair value measurement method for reporting purposes. SFAS No. 156 is effective as of the beginning of a company's first fiscal year that begins after September 15, 2006. The Company does not expect the adoption of SFAS No. 156 to have a material impact on the consolidated financial statements of the Company.

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In April 2006, the FASB issued FASB Staff Position ("FSP") FIN No. 46 (R)-6 "Determining the Variability to Be Considered in Applying Interpretation No. 46(R)." This FSP addresses how a reporting enterprise should determine the variability to be considered in applying FIN No. 46 (R). The variability that is considered affects the determination of (a) whether the entity is a variable interest entity, (b) which interests are variable interests in the entity, and (c) which party, if any, is the primary beneficiary of the VIE. This FSP states that the variability to be considered shall be based on an analysis of the design of the entity. This analysis includes reviewing the nature of the risks in the entity as well as determining the purpose for which the entity was created. This analysis also includes a determination of the variability that the entity was designed to create and pass along to its interest holders. The Company adopted FSP FIN46(R)-6 on September 1, 2006 on a prospective basis to all entities that the Company first becomes involved with and to all entities previously required to be analyzed under FIN No. 46 (R) when a reconsideration event has occurred. The Company does not expect the adoption of FSP FIN46(R)-6 to have a material impact on the consolidated financial statements of the Company.

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. FIN 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. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 must be implemented for fiscal years beginning after December 15, 2006. The Company is currently quantifying what impact, if any, the adoption of FIN 48 is expected to have on the consolidated financial statements of the Company.

In September 2006, the FASB issued 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. SFAS No. 157 requires companies to disclose the fair

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value of its financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined). Additionally, companies are required to provide enhanced disclosure regarding instruments in the level 3 category, including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing whether it will early adopt SFAS No. 157 as of the first quarter of fiscal 2007 as permitted, and is currently evaluating the impact adoption may have on the consolidated financial statements of the Company.

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2. FINANCIAL INSTRUMENTS

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

| (in thousands) | August 31, 2006 | November 30, 2005 |
|--|--------------------|----------------------|
| <hr style="border-top: 1px dashed black;"/> | | |
| FINANCIAL INSTRUMENTS OWNED: | | |
| US government and agency | \$ 6,818,959 | \$ 9,914,866 |
| Other sovereign governments | 262,385 | 1,159,265 |
| Corporate equity and convertible debt | 26,756,232 | 18,601,132 |
| Corporate debt and other | 31,949,428 | 21,571,914 |
| Mortgages, mortgage- and asset-backed | 41,851,588 | 40,297,016 |
| Derivative financial instruments | 15,147,673 | 14,700,228 |
| | ----- | ----- |
| | \$122,786,265 | \$106,244,421 |
| | ===== | ===== |
| | | |
| FINANCIAL INSTRUMENTS SOLD, BUT NOT YET PURCHASED: | | |
| US government and agency | \$ 13,099,272 | \$ 10,115,133 |
| Other sovereign governments | 604,720 | 1,617,998 |
| Corporate equity and convertible debt | 10,834,996 | 6,900,004 |
| Corporate debt and other | 3,590,791 | 3,274,034 |
| Mortgages, mortgage- and asset-backed | 209,039 | 139,988 |
| Derivative financial instruments | 12,720,095 | 12,957,176 |
| | ----- | ----- |
| | \$ 41,058,913 | \$ 35,004,333 |
| | ===== | ===== |

As of August 31, 2006 and November 30, 2005, all financial instruments owned that were pledged to counterparties where the counterparty has the right, by contract or custom, to rehypothecate those securities are classified as "Financial instruments owned and pledged as collateral" in the Condensed Consolidated Statements of Financial Condition.

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

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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 August 31, 2006 and November 30, 2005, the Company's most significant concentrations are related to US government and agency inventory positions, including those of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. In addition, a substantial portion of the collateral held by the Company for securities purchased under agreements to resell consists of securities issued by the US government and agencies.

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 and equity price risk. Derivative financial instruments represent contractual

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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

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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 attempts to mitigate its exposure to market risk by entering into hedging transactions, which may include over-the-counter derivative contracts or the purchase or sale of interest-bearing securities, equity securities, financial futures and forward contracts. In this regard, the utilization of derivative instruments is designed to reduce or mitigate market risks associated with holding dealer inventories or in connection with arbitrage-related trading activities.

Derivatives Credit Risk

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

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

Non-Trading Derivatives Activity

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

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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.

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SFAS No. 133, as amended by SFAS No. 138 and SFAS No. 149, establishes accounting and reporting standards for stand-alone derivative instruments, derivatives embedded within other contracts or securities and for hedging activities. It requires that all derivatives, whether stand-alone or embedded within other contracts or securities (except in very defined circumstances) be carried on the Company's Condensed Consolidated Statement of Financial Condition at fair value. SFAS No. 133 also requires items designated as being fair value hedged to be recorded at fair value, as defined in SFAS No. 133, provided that the intent to hedge is fully documented. Any resultant net change in value for both the hedging derivative and the hedged item is recognized in earnings immediately, such net effect being deemed the "ineffective" portion of the hedge. The gains and losses associated with the ineffective portion of the fair value hedges are included in "Principal transactions" revenues in the Condensed Consolidated Statements of Income. These amounts were immaterial for the three and nine months ended August 31, 2006 and 2005.

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 August 31, 2006 and November 30, 2005 was approximately 120 days and 90 days, respectively. These retained interests are included in "Financial instruments owned" in the Condensed Consolidated Statements of Financial Condition and are carried at fair value. Consistent with the valuation of similar inventory, fair value is determined by broker-dealer price quotations and internal valuation pricing models that utilize variables such as yield curves, prepayment speeds, default rates, loss severity, interest rate volatilities and spreads. The assumptions used for pricing variables are based on observable transactions in similar securities and are further verified by external pricing sources, when available.

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The Company's securitization activities are detailed below:

| (in billions) | Agency Mortgage-Backed | Other Mortgage- and Asset-Backed | Total |
|-----------------------------------|---------------------------|-------------------------------------|------------|
| ----- | | | |
| Total securitizations | | | |
| Nine months ended August 31, 2006 | \$ 17.6 | \$ 73.9 | \$ 91.5 |
| Nine months ended August 31, 2005 | \$ 20.5 | \$ 69.7 | \$ 90.2 |
| Retained interests | | | |
| As of August 31, 2006 | \$ 2.6 | \$ 4.2 | \$ 6.8 (1) |
| As of November 30, 2005 | \$ 1.8 | \$ 3.7 | \$ 5.5 (2) |
| ----- | | | |

(1) Includes approximately \$1.1 billion in non-investment-grade and unrated retained interests.

(2) Includes approximately \$0.8 billion in non-investment-grade and unrated retained interests.

The following table summarizes cash flows from securitization trusts related to securitization transactions during the nine months ended August 31, 2006 and August 31, 2005:

| (in Millions) | Agency Mortgage-Backed | Other Mortgage- and Asset-Backed | Total |
|---|---------------------------|-------------------------------------|----------|
| ----- | | | |
| Cash flows received from retained interests | | | |
| Nine months ended August 31, 2006 | \$ 208.4 | \$ 670.9 | \$ 879.3 |
| Nine months ended August 31, 2005 | \$ 288.9 | \$ 240.5 | \$ 529.4 |
| Cash flows from servicing | | | |
| Nine months ended August 31, 2006 | \$ 0.1 | \$ 55.9 | \$ 56.0 |
| Nine months ended August 31, 2005 | \$ 0.7 | \$ 34.4 | \$ 35.1 |
| ----- | | | |

The Company is an active market maker in these securities and therefore may retain interests in assets it securitizes, predominantly highly rated or government agency-backed securities. The models employed in the valuation of retained interests use discount rates that are based on the Treasury curve plus a spread. Key points on the constant maturity Treasury curve at August 31, 2006 were 4.78% for 2-year Treasuries and 4.80% for 10-year Treasuries, and ranged from 4.64% to 5.08%. These models also consider prepayment speeds as well as credit losses. Credit losses are considered through option-adjusted spreads that also incorporate additional factors such as liquidity and optionality.

Key economic assumptions used in measuring the fair value of retained interests in assets the Company securitized at August 31, 2006 were as follows:

| | Agency Mortgage-Backed | Other Mortgage- and Asset-Backed |
|---|---------------------------|-------------------------------------|
| ----- | | |
| Weighted average life (years) | 7.1 | 3.3 |
| Average prepayment speeds (annual rate) | 7%-30% | 8%-51% |
| Credit losses | - | 0%-9% |
| ----- | | |

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The following hypothetical sensitivity analysis as of August 31, 2006 illustrates the potential adverse change in fair value of these retained interests due to a specified change in the key valuation assumptions. The interest rate changes represent a parallel shift in the Treasury curve. This shift considers the effect of other variables, including prepayments. The remaining valuation assumptions are changed independently. Retained interests in securitizations are generally not held to maturity and are typically sold shortly after the settlement of a securitization. The Company considers the current and expected credit profile of the underlying collateral in determining the fair value and periodically updates the fair value for changes in credit, interest rate, prepayment and other pertinent market factors. Actual credit losses on retained interests have not been significant.

| (in millions) | Agency Mortgage-Backed | Other Mortgage- and Asset-Backed |
|--|---------------------------|-------------------------------------|
| ----- | | |
| Interest rates | | |
| Impact of 50 basis point adverse change | \$ (61.8) | \$ (89.4) |
| Impact of 100 basis point adverse change | (129.5) | (203.3) |
| ----- | | |
| Prepayment speeds | | |
| Impact of 10% adverse change | (2.9) | (34.9) |
| Impact of 20% adverse change | (5.0) | (66.2) |
| ----- | | |
| Credit spread | | |
| Impact of 10% adverse change | (6.4) | (76.2) |
| Impact of 20% adverse change | (12.7) | (146.5) |
| ----- | | |

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. At August 31, 2006, 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) | Sub- Prime Loans | Fixed- Rate Prime & Alt-A Loans | Adjustable-Rate Prime & Alt-A Loans |
|-----------------------------------|---------------------|---------------------------------------|---|
| Fair Value of MSRs | \$ 154.0 | \$ 98.7 | \$ 215.7 |
| Constant prepayment rate (in CPR) | 17% - 42% | 13% - 38% | 20% - 56% |
| Impact on fair value of: | | | |
| 5 CPR adverse change | \$ (16.6) | \$ (9.2) | \$ (11.6) |
| 10 CPR adverse change | (30.2) | (16.3) | (19.8) |
| Discount Rate | 15% | 13% | 13% |
| Impact on fair value of: | | | |
| 5% adverse change | \$ (12.3) | \$ (9.1) | \$ (11.0) |

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10% adverse change (22.5) (17.2) (22.6)

The previous tables 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 tables. 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 tables do not consider the change in fair value of hedging positions, which would generally offset the changes detailed in the tables, nor do they consider any corrective action that the Company may take in response to changes in these conditions. The impact of hedges is not presented because hedging positions are established on a portfolio level and allocating the impact would not be practicable.

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MSRs are included in "Other assets" on the Condensed Consolidated Statements of Financial Condition. The Company's MSR activities for the nine months ended August 31, 2006 and 2005 were as follows:

| (in millions) | August 31, 2006 | August 31, 2005 |
|------------------------------|--------------------|--------------------|
| Balance, beginning of period | \$ 431.1 | \$ 230.2 |
| Additions | 280.6 | 287.8 |
| Sales | (99.3) | (47.1) |
| Amortization | (143.3) | (93.6) |
| (Impairment)/Recovery | (0.7) | 2.7 |
| Balance, end of period | \$ 468.4 | \$ 380.0 |

Changes in the MSR valuation allowance for the nine months ended August 31, 2006 and 2005 were as follows:

| (in millions) | August 31, 2006 | August 31, 2005 |
|------------------------------|--------------------|--------------------|
| Balance, beginning of period | \$ (10.6) | \$ (33.7) |
| (Impairment)/Recovery | (0.7) | 2.7 |
| Balance, end of period | \$ (11.3) | \$ (31.0) |

5. VARIABLE INTEREST ENTITIES AND MORTGAGE LOAN SPECIAL PURPOSE ENTITIES

The Company regularly creates or transacts with entities that may be VIEs. These entities are an essential part of its securitization, asset management and structured finance businesses. In addition, the Company purchases and sells financial instruments that may be variable interests. The Company adopted FIN No. 46 (R) for its variable interests in fiscal 2004. The Company consolidates those VIEs in which the Company is the primary beneficiary.

The Company may perform various functions, including being the seller,

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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 is the primary beneficiary often through its ownership of certain beneficial interests, and is, therefore, required to consolidate the assets and liabilities of the VIE.

The Company has a limited number of mortgage securitizations that did not meet the criteria for sale treatment under SFAS No. 140 because the securitization vehicles were not QSPEs. The assets in these mortgage securitizations approximated \$12.0 billion and \$5.3 billion at August 31, 2006 and November 30, 2005, respectively. At August 31, 2006 and November 30, 2005, the Company's maximum exposure to loss as a result of its relationship with mortgage securitizations is approximately \$486.2 million and \$299.4 million, respectively, which represents the fair value of its interests in the mortgage securitizations.

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The Company has retained call options on a limited number of securitization transactions that require the Company to continue recognizing the assets subject to the call options. The total assets in these transactions approximated \$11.2 billion and \$8.7 billion, at August 31, 2006 and November 30, 2005, respectively.

Assets held by VIEs, which are currently consolidated because the Company is the primary beneficiary, approximated \$1.4 billion and \$1.2 billion at August 31, 2006 and November 30, 2005, respectively. At August 31, 2006 and November 30, 2005, the Company's maximum exposure to loss as a result of its relationship with these VIEs is approximately \$375.6 million and \$531.0 million, respectively, which represents the fair value of its interests in the VIEs.

The Company also owns significant variable interests in several VIEs related to collateralized debt obligations or asset securitizations for which the Company is not the primary beneficiary and therefore does not consolidate these entities. In aggregate, these VIEs have assets approximating \$10.9 billion and \$4.7 billion at August 31, 2006 and November 30, 2005, respectively. At August 31, 2006 and November 30, 2005, the Company's maximum exposure to loss from these entities approximated \$141.0 million and \$29.6 million, respectively, which represents the fair value of its interests and is reflected on the Condensed Consolidated Statements of Financial Condition.

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

The Company was the general partner of certain limited partnerships in which the limited partners did not have sufficient voting or control rights. Under EITF No. 04-5, the Company was required to consolidate these

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limited partnerships. The assets held by the limited partnerships approximated \$422.8 million as of August 31, 2006. The Company's maximum exposure to loss as a result of its relationship with these limited partnerships is approximately \$13.9 million as of August 31, 2006, which represents the fair value of its interests and is reflected on the Condensed Consolidated Statements of Financial Condition.

6. COLLATERALIZED FINANCING ARRANGEMENTS

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

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

At August 31, 2006 and November 30, 2005, the fair value of securities received as collateral by the Company that can be repledged, delivered or otherwise used was approximately \$258.8 billion and \$254.6 billion, respectively. Of these securities received as collateral, those with a fair value of approximately \$183.5 billion and \$184.3 billion were delivered or repledged at August 31, 2006 and November 30, 2005, respectively.

The Company also pledges financial instruments owned to collateralize certain financing arrangements and permits the counterparty to pledge or rehypothecate the securities. These securities are recorded as "Financial instruments owned and pledged as collateral, at fair value" in the Condensed Consolidated Statements of Financial Condition. The carrying value of securities and other inventory positions owned that have been pledged or otherwise encumbered to counterparties where those counterparties do not have the right to sell or repledge was approximately \$29.8 billion and \$20.8 billion at August 31, 2006 and November 30, 2005, respectively.

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

7. LONG-TERM BORROWINGS

The Company's long-term borrowings (which have original maturities of at least 12 months) at August 31, 2006 and November 30, 2005 consisted of the following:

| (in thousands) | August 31, 2006 | November 30, 2005 |
|--------------------------------------|--------------------|----------------------|
| Fixed rate notes due 2006 to 2036 | \$21,108,324 | \$21,973,171 |
| Floating rate notes due 2006 to 2036 | 20,570,080 | 14,208,786 |
| Index/equity/credit-linked notes | 8,522,994 | 7,307,659 |
| Total long-term borrowings | \$50,201,398 | \$43,489,616 |
| | ===== | ===== |

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The Company's long-term borrowings include fair value adjustments in accordance with SFAS No. 133. During the nine months ended August 31, 2006, the Company issued and retired/repurchased \$13.4 billion and \$7.6 billion of long-term borrowings, respectively. The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 4.2 years at August 31, 2006.

8. EARNINGS PER SHARE

Basic EPS is computed by dividing net income applicable to common shares, adjusted for costs related to vested shares under the CAP Plan, as well as the effect of the redemption of preferred stock, by the weighted average number of common shares outstanding. Common shares outstanding includes vested units issued under certain stock compensation plans, which will be distributed as shares of common stock. Diluted EPS includes the determinants of basic EPS and, in addition, gives effect to dilutive potential common shares related to stock compensation plans.

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

| (in thousands, except per share amounts) | Three Months Ended | | Nine Mont |
|--|--------------------|--------------------|--------------------|
| | August 31, 2006 | August 31, 2005 | August 31, 2006 |
| Net income | \$ 437,556 | \$ 378,305 | \$ 1,491,045 |
| Preferred stock dividends | (5,316) | (5,948) | (16,106) |
| Redemption of preferred stock | 28 | - | 55 |
| Income adjustment (net of tax) applicable to deferred compensation arrangements-vested shares | 8,793 | 13,659 | 33,166 |
| Net earnings used for basic EPS | 441,061 | 386,016 | 1,508,160 |
| Income adjustment (net of tax) applicable to deferred compensation arrangements-nonvested shares | 8,057 | 8,903 | 28,523 |
| Net earnings used for diluted EPS | \$ 449,118 | \$ 394,919 | \$ 1,536,683 |
| Total basic weighted average common shares outstanding (1) | 132,086 | 130,194 | 132,540 |
| Effect of dilutive securities: | | | |
| Employee stock options | 5,966 | 3,949 | 5,842 |
| CAP and restricted units | 10,847 | 12,909 | 11,103 |
| Dilutive potential common shares | 16,813 | 16,858 | 16,945 |
| Weighted average number of common shares outstanding and dilutive potential common shares | 148,899 | 147,052 | 149,485 |
| Basic EPS | \$ 3.34 | \$ 2.96 | \$ 11.38 |
| Diluted EPS | \$ 3.02 | \$ 2.69 | \$ 10.28 |

(1) Includes 12,949,398 and 17,313,461 vested units for the three months ended August 31, 2006 and August 31, 2005, respectively, and

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12,059,414 and 18,351,893 vested units for the nine months ended August 31, 2006 and August 31, 2005, respectively, issued under stock compensation plans which will be distributed as shares of common stock.

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

9. REGULATORY REQUIREMENTS

Effective December 1, 2005, the Company became regulated by the SEC as a consolidated supervised entity ("CSE"). As a CSE, the Company is subject to group-wide supervision and examination by the SEC and is required to compute allowable capital and allowances for market, credit and operational risk on a consolidated basis. As of August 31, 2006, the Company was in compliance with the CSE capital requirements.

Bear Stearns and BSSC are registered broker-dealers and futures commission merchants and, accordingly, are subject to Rule 15c3-1 under the Securities Exchange Act of 1934 ("Net Capital Rule") and Rule 1.17 under the Commodity Futures Trading Commission. Effective December 1, 2005, the SEC approved Bear Stearns' use of Appendix E of the Net Capital Rule which establishes alternative net capital requirements for broker-dealers that are part of consolidated supervised entities. Appendix E allows Bear Stearns to calculate net capital charges for market risk and derivatives-related credit risk based on mathematical models provided that Bear Stearns holds tentative net capital in excess of \$1 billion and net capital in excess of \$500 million. At August 31, 2006, Bear Stearns' net capital of \$5.55 billion exceeded the minimum requirement by \$5.00 billion. Bear Stearns' net capital computation, as defined, includes \$830.4 million, which is net capital of BSSC in excess of 5.5% of aggregate debit items arising from customer transactions.

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

BSB, an Ireland-based bank principally involved in the trading and sales of fixed income products, is registered in Ireland and is subject to the regulatory capital requirements of the Financial Regulator.

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

At August 31, 2006, Bear Stearns, BSSC, BSIL, BSIT, BSB and CTC are in compliance with their respective regulatory capital requirements. Certain other subsidiaries are subject to various securities regulations and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. At August 31, 2006, these other subsidiaries were in compliance with their applicable local capital adequacy requirements.

10. COMMITMENTS AND CONTINGENCIES

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

Leases

The Company occupies office space under leases that expire at various dates through 2024. At August 31, 2006, future minimum aggregate annual rentals payable under non-cancelable leases (net of subleases), including 383 Madison Avenue in New York City, for fiscal years 2006 through 2010 and the aggregate amount thereafter, are as follows:

(in thousands)

| ----- | |
|------------------|------------|
| FISCAL YEAR | |
| 2006 (remaining) | \$ 20,490 |
| 2007 | 89,547 |
| 2008 | 90,972 |
| 2009 | 86,845 |
| 2010 | 89,427 |
| Thereafter | 572,002 |
| | ----- |
| Total | \$ 949,283 |
| | ===== |

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

Lending - Related Commitments

In connection with certain of the Company's business activities, the Company provides financing or financing commitments to investment-grade and non-investment-grade companies in the form of senior and subordinated debt, including bridge financing. Commitments have varying maturity dates and are generally contingent on the accuracy and validity of certain representations, warranties and contractual conditions applicable to the borrower. Lending-related commitments to investment-grade borrowers aggregated approximately \$3.2 billion and \$2.4 billion at August 31, 2006 and November 30, 2005, respectively. Of these amounts, approximately \$825.0 million and \$652.5 million were economically hedged at August 31, 2006 and November 30, 2005, respectively. Lending-related commitments to non-investment-grade borrowers approximated \$2.5 billion and \$1.4 billion at August 31, 2006 and November 30, 2005, respectively.

The Company also had contingent commitments to investment-grade and non-investment-grade companies of approximately \$5.2 billion and \$3.9 billion as of August 31, 2006 and November 30, 2005, respectively. Generally, these commitments are provided in connection with leveraged acquisitions. These commitments are not indicative of the Company's actual risk because the borrower may never draw upon the commitment. In fact, the borrower may not be successful in the acquisition, the borrower may access the capital markets instead of drawing on the commitment, or the Company's portion of the commitment may be reduced through the syndication process. Additionally, the borrower's ability to draw may be subject to there being no material adverse change in either market conditions or the borrower's

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financial condition, among other factors. These commitments generally contain certain flexible pricing features to adjust for changing market conditions prior to closing.

Private Equity-Related Investments and Partnerships

In connection with the Company's merchant banking activities, the Company has commitments to invest in merchant banking and private equity-related investment funds as well as commitments to invest directly in private equity-related investments. At August 31, 2006 and November 30, 2005, such commitments aggregated \$729.2 million and \$222.1 million, respectively. These commitments will be funded, if called, through the end of the respective investment periods, with the longest of such periods ending in 2017.

Underwriting

In connection with the Company's mortgage-backed securitizations and fixed income underwriting, the Company had commitments to purchase new issues of securities aggregating \$218.1 million and \$943.1 million, respectively, at August 31, 2006 and November 30, 2005.

Commercial and Residential Loans

The Company participates in the acquisition, origination, securitization, servicing, financing and disposition of commercial and residential loans. At August 31, 2006 and November 30, 2005, the Company had entered into commitments to purchase or finance mortgage loans of \$4.8 billion and \$5.1 billion, respectively.

Letters of Credit

At August 31, 2006 and November 30, 2005, the Company was contingently liable for unsecured letters of credit of approximately \$3.2 billion and \$2.5 billion, respectively, and letters of credit of \$1.8 billion and \$985.6 million, respectively, secured by financial instruments, primarily used to provide collateral for securities borrowed and to satisfy margin requirements at option and commodity exchanges.

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

Litigation

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

Because litigation is inherently unpredictable, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss related to such matters,

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how such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief might be. Consequently, the Company cannot estimate losses or ranges of losses for matters where there is only a reasonable possibility that a loss may have been incurred. Although the ultimate outcome of these matters cannot be ascertained at this time, it is the opinion of management, after consultation with counsel, that the resolution of the foregoing matters will not have a material adverse effect on the financial condition of the Company, taken as a whole; such resolution may, however, have a material effect on the operating results in any future period, depending on the level of income for such period.

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

Tax

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

Other

The Company had commitments to purchase Chapter 13 and other credit card receivables of \$98.1 million and \$159.8 million, respectively, at August 31, 2006 and November 30, 2005.

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

11. GUARANTEES

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

The guarantees covered by FIN No. 45 include contracts that contingently require the guarantor to make payments to the guaranteed party based on changes related to an asset, a liability or an equity security of the guaranteed party, contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement and indirect guarantees of the indebtedness of others, even though

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(UNAUDITED)

the payment to the guaranteed party may not be based on changes to an asset, liability or equity security of the guaranteed party. In addition, FIN No. 45 covers certain indemnification agreements that contingently require the guarantor to make payments to the indemnified party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.

The following table sets forth the maximum payout/notional amounts associated with the Company's guarantees as of August 31, 2006:

| (in millions) | Amount of Guarantee Expiration Per Period | | | |
|---|---|-----------------------|------------------------|----------------------------|
| | Less Than One Year | One to Three Years | Three to Five Years | Greater than Five Years |
| Certain derivative contracts (notional) (1) | \$ 97,825 | \$ 359,721 | \$ 284,368 | \$ 443,378 |
| Municipal securities | 2,459 | 388 | - | - |
| Residual value guarantee | - | - | 570 | - |

(1) The carrying value of these derivatives approximated \$1.3 billion as of August 31, 2006.

Derivative Contracts

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

On certain of these contracts, such as written interest rate caps and foreign currency options, the maximum payout cannot be quantified since the increase in interest rates and foreign exchange rates is not contractually limited by the terms of the contracts. As such, the Company has disclosed notional amounts as a measure of the extent of its involvement in these classes of derivatives rather than maximum payout. Notional amounts do not represent the maximum payout and generally overstate the Company's exposure to these contracts. These derivative contracts are recorded at fair value, which approximated \$1.3 billion at August 31, 2006.

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

Municipal Securities

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In 1997, the Company established a program whereby it created a series of municipal securities trusts in which it has retained interests. These trusts purchase fixed-rate, long-term, highly rated, insured or escrowed municipal bonds financed by the issuance of trust certificates. Certain of the trust certificates entitle the holder to receive future payments of principal and variable interest and to tender such certificates at the option of the holder on a periodic basis. The Company acts as placement agent and as liquidity provider. The purpose of the program is to allow the Company's clients to purchase synthetic short-term, floating-rate municipal debt that does not otherwise exist in the marketplace. In the Company's capacity as liquidity provider to the trusts, the maximum exposure to loss at August 31, 2006 was approximately \$2.85 billion, which represents the outstanding amount of all trust certificates. This exposure to loss is mitigated by the underlying municipal bonds held by trusts. The underlying municipal bonds in the trusts are either AAA or AA rated, insured or escrowed to maturity. Such bonds had a market value, net of related hedges, approximating \$2.94 billion at August 31, 2006.

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

Residual Value Guarantee

The Company has entered into an operating lease arrangement for its world headquarters at 383 Madison Avenue in New York City (the "Synthetic Lease"). Under the terms of the Synthetic Lease, the Company is obligated to make monthly payments based on the lessor's underlying interest costs. The Synthetic Lease expires on August 12, 2011 unless both parties agree to a renewal prior to expiration. At the expiration date of the Synthetic Lease, the Company has the right to purchase the building for the amount of the then outstanding indebtedness of the lessor or to arrange for the sale of the property with the proceeds of the sale to be used to satisfy the lessor's debt obligation. If the sale of the property does not generate sufficient proceeds to satisfy the lessor's debt obligation, the Company is required to fund the shortfall up to a maximum residual value guarantee. As of August 31, 2006, there was no expected shortfall and the maximum residual value guarantee approximated \$570 million.

Indemnifications

The Company provides representations and warranties to counterparties in connection with a variety of commercial transactions, including certain asset sales and securitizations and occasionally indemnifies them against potential losses caused by the breach of those representations and warranties. To mitigate these risks with respect to assets being securitized that have been originated by third parties, the Company seeks to obtain appropriate representations and warranties from such third-party originators upon acquisition of such assets. The Company generally performs due diligence on assets purchased and maintains underwriting standards for assets originated. The Company may also provide indemnifications to some counterparties to protect them in the event additional taxes are owed or payments are withheld, due either to a change in or adverse interpretation of certain tax laws. These indemnifications generally are standard contractual terms and are entered into in the normal course of business. Generally, there are no stated or notional amounts included in these indemnifications, and the contingencies triggering the obligation to indemnify are not expected to occur.

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Maximum payout information under these indemnifications is not readily available because of the number, size and duration of these transactions. In implementing this accounting interpretation, the Company reviewed its experience with the indemnifications on these structures. Based on such experience, it is unlikely that the Company will have to make significant payments under these arrangements.

Other Guarantees

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

12. SEGMENT DATA

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

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

Institutional equities consists of research, sales and trading in areas such as domestic and international equities, block trading, convertible bonds, over-the-counter equities, equity derivatives, risk and convertible arbitrage and

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

the NYSE, American Stock Exchange and International Securities Exchange specialist activities. Fixed income includes sales, trading and research provided to institutional clients across a variety of products such as mortgage- and asset-backed securities, corporate and government bonds, municipal bonds, high yield products, foreign exchange, and interest rate and credit derivatives. Investment banking provides services in capital raising, strategic advice, mergers and acquisitions and merchant banking. Capital raising encompasses the Company's underwriting of equity, investment-grade, municipal and high yield debt products.

The Global Clearing Services segment provides execution, clearing, margin lending and securities borrowing to facilitate customer short sales to clearing clients worldwide. Prime brokerage clients include hedge funds

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and clients of money managers, short sellers and other professional investors. Fully disclosed clients engage in either the retail or institutional brokerage business.

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

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

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

| (in thousands) | Three Months ended | | Nine Months ended | |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|
| | August 31, 2006 | August 31, 2005 | August 31, 2006 | August 31, 2005 |
| NET REVENUES | | | | |
| Capital Markets | | | | |
| Institutional Equities | \$ 435,543 | \$ 333,620 | \$ 1,478,506 | \$ 1,037,013 |
| Fixed Income | 877,910 | 739,242 | 2,933,956 | 2,412,762 |
| Investment Banking | 232,253 | 299,935 | 807,252 | 749,264 |
| Total Capital Markets | 1,545,706 | 1,372,797 | 5,219,714 | 4,199,039 |
| Global Clearing Services | 269,351 | 258,042 | 822,866 | 804,594 |
| Wealth Management | | | | |
| Private Client Services (1) | 127,304 | 113,897 | 384,987 | 333,409 |
| Asset Management | 104,040 | 55,686 | 220,697 | 161,149 |
| Total Wealth Management | 231,344 | 169,583 | 605,684 | 494,558 |
| Other (2) | 82,734 | 11,858 | 165,516 | 25,301 |
| Total net revenues | \$ 2,129,135 | \$ 1,812,280 | \$ 6,813,780 | \$ 5,523,492 |
| PRE-TAX INCOME | | | | |
| Capital Markets | \$ 499,824 | \$ 492,155 | \$ 1,836,580 | \$ 1,429,614 |
| Global Clearing Services | 113,968 | 127,486 | 382,585 | 408,249 |

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| | | | | |
|----------------------|------------|------------|--------------|--------------|
| Wealth Management | 20,737 | 4,894 | 39,593 | 25,927 |
| Other (2) | 32,709 | (44,380) | (4,968) | (242,868) |
| | ----- | ----- | ----- | ----- |
| Total pre-tax income | \$ 667,238 | \$ 580,155 | \$ 2,253,790 | \$ 1,620,922 |
| | ===== | ===== | ===== | ===== |

| | Three Months ended | | Nine Mo |
|---|--------------------|--------------------|--------------------|
| | August 31, 2006 | August 31, 2005 | August 31, 2006 |
| | ----- | ----- | ----- |
| (1) Private Client Services detail: | | | |
| Gross revenues, before transfer to Capital Markets segment | \$ 148,404 | \$ 138,987 | \$ 454,496 |
| Revenue transferred to Capital Markets segment | (21,100) | (25,090) | (69,509) |
| Private Client Services net revenues | \$ 127,304 | \$ 113,897 | \$ 384,987 |
| | ===== | ===== | ===== |

(2) Includes consolidation and elimination entries, unallocated revenues (predominantly interest), and certain corporate administrative functions, including certain legal costs and costs related to the CAP Plan. CAP Plan costs were \$29.5 million and \$39.5 million for the three months ended August 31, 2006 and August 31, 2005, respectively and \$108.0 million and \$109.0 million for the nine months ended August 31, 2006 and August 31, 2005, respectively.

| | As of | | |
|--------------------------|--------------------|----------------------|--------------------|
| (in thousands) | August 31, 2006 | November 30, 2005 | August 31, 2005 |
| | ----- | ----- | ----- |
| SEGMENT ASSETS | | | |
| Capital Markets | \$ 225,635,555 | \$ 195,292,625 | \$ 186,104,87 |
| Global Clearing Services | 98,194,112 | 85,625,396 | 88,909,59 |
| Wealth Management | 3,032,653 | 2,751,749 | 2,440,00 |
| Other | 7,898,000 | 8,965,463 | 7,072,21 |
| | ----- | ----- | ----- |
| Total segment assets | \$ 334,760,320 | \$ 292,635,233 | \$ 284,526,68 |
| | ===== | ===== | ===== |

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
The Bear Stearns Companies Inc.

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We have reviewed the accompanying condensed consolidated statement of financial condition of The Bear Stearns Companies Inc. and subsidiaries as of August 31, 2006, and the related condensed consolidated statements of income for the three-month and nine-month periods ended August 31, 2006 and 2005 and cash flows for the nine-month periods ended August 31, 2006 and 2005. These interim financial statements are the responsibility of The Bear Stearns Companies Inc.'s management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of The Bear Stearns Companies Inc. and subsidiaries as of November 30, 2005, and the related consolidated statements of income, cash flows and changes in stockholders' equity for the fiscal year then ended (not presented herein) included in The Bear Stearns Companies Inc.'s Annual Report on Form 10-K for the fiscal year ended November 30, 2005, as amended by Amendment No. 1 thereto on Form 10-K/A; and in our report dated February 10, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial condition as of November 30, 2005 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

/s/ Deloitte & Touche LLP

New York, New York
October 9, 2006

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

INTRODUCTION

The Bear Stearns Companies Inc. (the "Company") is a holding company that through its broker-dealer and international bank subsidiaries, principally Bear, Stearns & Co. Inc. ("Bear Stearns"), Bear, Stearns Securities Corp. ("BSSC"), Bear, Stearns International Limited ("BSIL") and Bear Stearns Bank plc ("BSB"), is a leading investment banking, securities and derivatives trading, clearance and brokerage firm serving corporations, governments, institutional and individual investors worldwide. BSSC, a subsidiary of Bear Stearns, provides professional and correspondent clearing services in addition to clearing and

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settling customer transactions and certain proprietary transactions of the Company. The Company also conducts significant activities through other wholly owned subsidiaries, including: Bear Stearns Global Lending Limited; Custodial Trust Company; Bear Stearns Financial Products Inc.; Bear Stearns Capital Markets Inc.; Bear Stearns Credit Products Inc.; Bear Stearns Forex Inc.; EMC Mortgage Corporation; and Bear Stearns Commercial Mortgage, Inc. and through its majority owned subsidiary Bear Hunter Holdings LLC. The Company is primarily engaged in business as a securities broker-dealer operating in three principal segments: Capital Markets, Global Clearing Services and Wealth Management. As used in this report, the "Company" refers (unless the context requires otherwise) to The Bear Stearns Companies Inc. and its subsidiaries. Unless specifically noted otherwise, all references to the three and nine months of 2006 and 2005 refer to the three and nine months ended August 31, 2006 and August 31, 2005, respectively, and all references to quarters are to the Company's fiscal quarters.

For a description of the Company's business, including its trading in cash instruments and derivative products, its underwriting and trading policies, and their respective risks, and the Company's risk management policies and procedures, see the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2005, as amended by Amendment No. 1 thereto on Form 10-K/A, each as filed by the Company under the Securities Exchange Act of 1934, as amended ("Exchange Act") (together, the "Form 10-K").

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

CERTAIN FACTORS AFFECTING RESULTS OF OPERATIONS

The Company's principal business activities--investment banking, securities and derivatives sales and trading, clearance, brokerage and asset management--are, by their nature, highly competitive and subject to various risks, including volatile trading markets and fluctuations in the volume of market activity. Consequently, the Company's net income and revenues have been, and are likely to continue to be, subject to wide fluctuations, reflecting the effect of many factors, including general economic conditions, securities market conditions, the level and volatility of interest rates and equity prices, competitive conditions, liquidity of global markets, international and regional political conditions, regulatory and legislative developments, monetary and fiscal policy, investor sentiment, availability and cost of capital, technological changes and events, outcome of legal proceedings, changes in currency values, inflation, credit ratings and the size, volume and timing of transactions.

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

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liquidity risks. For a discussion of how the Company seeks to manage risks, see the "Risk Management" and "Liquidity and Capital Resources" sections of the Form 10-K.

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

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

FORWARD-LOOKING STATEMENTS

Certain statements contained in this discussion are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements concerning management's expectations, strategic objectives, business prospects, anticipated economic performance and financial condition and other similar matters are subject to risks and uncertainties, including those described in the prior paragraphs, which could cause actual results to differ materially from those discussed in the forward-looking statements. Forward-looking statements speak only as of the date of the document in which they are made. We disclaim any obligation or undertaking to provide any updates or revisions to any forward-looking statement to reflect any change in our expectations or any change in events, conditions or circumstances on which the forward-looking statement is based.

EXECUTIVE OVERVIEW

Summary of Results

Revenues, net of interest expense ("net revenues") for the three months ended August 31, 2006 increased 17.5% to \$2.13 billion from \$1.81 billion for the three months ended August 31, 2005, while pre-tax earnings increased 15.0% during the same period. The pre-tax profit margin for the 2006 quarter decreased to 31.3% when compared with 32.0% in the 2005 quarter. Annualized return on average common equity was 15.8% for the quarter ended August 31, 2006 versus 16.9% in the prior year quarter.

Capital Markets net revenues increased 12.6% to \$1.55 billion for the 2006 quarter compared to \$1.37 billion for the 2005 quarter. Within the Capital Markets segment, institutional equities net revenues increased 30.6% to \$435.5 million for the 2006 quarter from \$333.6 million for the 2005 quarter. Energy and commodity revenues contributed to the increase in institutional equities net revenues, reflecting gains from the sale of certain commodity assets. Equity derivatives net revenues increased on strong market conditions and active institutional and corporate customer volumes. International equity sales and trading net revenues also increased, benefiting from continued strength in European and Asian equities. Fixed income net revenues increased 18.8% to \$877.9 million for the 2006 quarter from \$739.2 million for the 2005 quarter. The Company's credit derivatives business reached record levels in the 2006 quarter on higher levels of customer activity. Net revenues from the leveraged finance area also increased on higher levels of acquisition related finance activity. Mortgage-backed securities revenues increased despite the 175 basis point increase in short-term rates and significant flattening of the yield curve.

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Commercial mortgage and collateralized debt obligations ("CDO") net revenues increased significantly when compared to the prior year quarter as securitization volumes rose on favorable investor demand and market share gains. Investment banking revenues decreased 22.6% to \$232.3 million for the 2006 quarter from \$299.9 million for the 2005 quarter, primarily reflecting a decrease in merchant banking revenues as well as a decrease in equity underwriting activity as the volume of lead and co-managed initial public offerings ("IPO") and equity follow-on offerings declined in a less favorable market environment. These declines in investment banking were partially offset by an increase in mergers and acquisitions ("M&A") fees resulting from higher levels of completed M&A activity.

Global Clearing Services net revenues increased 4.4% to \$269.4 million for the 2006 quarter from \$258.0 million for the 2005 quarter. An increase in average customer margin and short sale balances contributed to an increase in net interest revenues, partially offset by a decline in commission revenues.

Wealth Management net revenues increased 36.4% to \$231.3 million for the 2006 quarter from \$169.6 million for the 2005 quarter, reflecting growth in fee-based assets in the Company's private client services ("PCS") business. Asset management revenues also increased in the 2006 quarter, primarily due to increased performance fees on proprietary hedge fund products and increased management fees on higher levels of assets under management.

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

Business Environment

Fiscal 2006 Quarter

The business environment during the third quarter ended August 31, 2006 was generally favorable due to a combination of factors including an expanding US economy, low interest rates and low unemployment. The Federal Reserve Board (the "Fed") met twice during the quarter and raised the federal funds rate from 5.00% to 5.25% during its first meeting and kept the federal funds rate unchanged at 5.25% at its second meeting citing moderating economic growth from its strong pace earlier in the year, a gradual cooling of the housing market and higher energy prices. In August 2006, the unemployment rate was at 4.7%, up from 4.6% at the end of the second quarter. Oil prices declined slightly to close at \$70 a barrel at the end of August, down 1.4% from the prior quarter's close of \$71.

The major indices were all up during the third quarter of 2006. The Dow Jones Industrial Average ("DJIA"), Nasdaq Composite Index ("NASDAQ") and Standard & Poor's 500 Index ("S&P 500") increased 1.9%, 0.2% and 2.7%, respectively. Average daily trading volume on the Nasdaq and New York Stock Exchange ("NYSE") increased 14.9% and 12.8%, respectively, in the 2006 quarter, compared to the 2005 quarter. Industry-wide US announced M&A volumes increased 25.3% while industry-wide US-completed M&A volumes decreased 19.2% compared to the comparable prior year quarter. Total equity issuance volumes decreased 27.0% industry-wide while IPO volumes decreased 55.4% industry-wide compared to the 2005 quarter.

Fixed income activity continued to be robust during the 2006 quarter compared with the comparable prior year quarter despite the increase in short-term interest rates and a flattening yield curve. Long-term interest rates, as measured by the 10-year Treasury bond, decreased during the 2006 quarter. The 10-year Treasury bond yield decreased to 4.73% at the end of the 2006 quarter from 5.11% at the beginning of the quarter. The housing market experienced

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declines in refinancing and purchasing levels during the 2006 quarter. Overall, US mortgage-backed securities new issue volume decreased 3.9% industry-wide during the 2006 quarter compared with the 2005 quarter. Agency collateralized mortgage obligation ("CMO") volumes increased 8.2%, while non-agency mortgage-backed and commercial mortgage-backed origination volumes decreased approximately 0.1% and 32.4%, respectively, industry-wide during the 2006 quarter from the levels reached in the 2005 quarter.

Fiscal 2005 Quarter

The business environment during the Company's third quarter ended August 31, 2005 was generally favorable due to a combination of factors including an expanding US economy, continued low interest rates and low inflation. Favorable job reports and an active housing market provided ongoing support to economic activity. The unemployment rate dropped to 4.9% in August 2005. Oil prices, however, soared during the 2005 quarter. The price per barrel increased from \$54 at the beginning of the quarter to \$69 at August 31, 2005 raising concerns about the effect on overall economic activity. The Fed met twice during the quarter and continued its measured pace of interest rate increases, raising the federal funds rate, in 25 basis point increments, from 3.00% to 3.50%. They were the 9th and 10th straight 25 basis point increase since June 2004.

The major equity indices all increased during the third quarter of 2005. The DJIA, the NASDAQ and the S&P 500 increased 0.1%, 4.1% and 2.4%, respectively, during the 2005 quarter, compared to the 2004 quarter. Average daily trading volume on the NYSE and Nasdaq increased 8.3% and 5.3%, respectively, compared to the 2004 quarter. Industry-wide announced M&A volumes increased 35.9% while industry-wide completed M&A volumes increased 31.3% in the 2005 quarter compared to the 2004 quarter. Total equity issuance increased 38.5% in the 2005 quarter compared with the 2004 quarter.

Fixed income activity was robust during the 2005 quarter despite a more challenging environment associated with higher short-term interest rates and a flattening yield curve. While the Fed continued to raise the federal funds rate during the 2005 quarter, long-term interest rates, as measured by the 10-year Treasury bond, remained relatively stable during the 2005 quarter. The 10-year Treasury bond yield was 4.01% at the end of the third quarter, approximately the same level it was at the beginning of the quarter. The mortgage purchase index increased approximately 11% compared to the 2004 quarter reflecting low interest rates and the strong home purchasing market. Agency CMO and non-agency volumes continued to achieve high levels during the quarter. Overall mortgage-backed securities new issue volume increased 7.6% during the 2005 quarter compared with the 2004 quarter.

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

RESULTS OF OPERATIONS

Firmwide Results

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

| (in thousands, except per share amounts, pre-tax profit margin and return on average | Three Months Ended | | |
|---|--------------------|------------|--------|
| | August 31, | August 31, | August |

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| common equity) | 2006 | 2005 | % Increase | 2006 |
|--|--------------|--------------|------------|----------|
| Revenues, net of interest expense | \$ 2,129,135 | \$ 1,812,280 | 17.5% | \$ 6,813 |
| Income before provision for income taxes | \$ 667,238 | \$ 580,155 | 15.0% | \$ 2,253 |
| Net Income | \$ 437,556 | \$ 378,305 | 15.7% | \$ 1,491 |
| Diluted earnings per share | \$ 3.02 | \$ 2.69 | 12.3% | \$ 1 |
| Pre-tax profit margin | 31.3% | 32.0% | | |
| Return on average common equity (annualized) | 15.8% | 16.9% | | |

The Company reported net income of \$437.6 million, or \$3.02 per share (diluted), for the 2006 quarter, which represented an increase of 15.7% from \$378.3 million, and an increase of 12.3% from \$2.69 per share (diluted), for the 2005 quarter. Net revenues increased 17.5% to \$2.13 billion for the 2006 quarter from \$1.81 billion for the 2005 quarter, due to increases in principal transactions revenues, net interest revenues, and asset management and other revenues, partially offset by decreases in investment banking revenues and commission revenues.

The Company reported net income of \$1.49 billion, or \$10.28 per share (diluted), for the nine months ended August 31, 2006, which represented an increase of 41.3% from \$1.06 billion, and 38.5% from \$7.42 per share (diluted), for the nine months ended August 31, 2005. Net revenues increased 23.4% to \$6.81 billion for the 2006 period from \$5.52 billion for the 2005 period, due to increases in principal transactions revenues, net interest revenues, investment banking revenues, and asset management and other revenues, partially offset by a decrease in commission revenues.

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

| (in thousands) | Three Months Ended | | | Nine Months Ended | | |
|-------------------|--------------------|-----------------|------------------------|-------------------|-----------------|-----------------------|
| | August 31, 2006 | August 31, 2005 | % Increase/ (Decrease) | August 31, 2006 | August 31, 2005 | % Increase (Decrease) |
| Institutional | \$ 193,203 | \$ 188,600 | 2.4 % | \$ 587,179 | \$ 581,938 | 0.9 % |
| Clearance | 54,882 | 62,882 | (12.7%) | 176,685 | 197,494 | (10.5%) |
| Retail | 31,948 | 39,317 | (18.7%) | 107,491 | 122,352 | (12.1%) |
| Total commissions | \$ 280,033 | \$ 290,799 | (3.7%) | \$ 871,355 | \$ 901,784 | (3.4%) |

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

Commission revenues decreased 3.7% to \$280.0 million for the 2006 quarter from \$290.8 million for the 2005 quarter. Institutional commissions increased 2.4% to \$193.2 million for the 2006 quarter from \$188.6 million for the 2005 quarter due to increased average trading volumes. Clearance commissions decreased 12.7% to \$54.9 million for the 2006 quarter from \$62.9 million for the 2005 quarter, reflecting lower volumes and average rates from prime brokerage clients and lower average rates from fully disclosed clients. Retail commissions were \$31.9 million in the 2006 quarter, down 18.7% from \$39.3 million in the 2005 quarter due to the business shifting some accounts from a commission to fee-based structure.

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Commission revenues decreased 3.4% to \$871.4 million for the nine months ended August 31, 2006 from \$901.8 million for the 2005 period. Institutional commissions increased 0.9% to \$587.2 million for the 2006 period from \$581.9 million for the 2005 period due to increased average trading volumes. Clearance commissions decreased 10.5% to \$176.7 million for the 2006 period from \$197.5 million for the 2005 period, reflecting lower volumes and average rates from prime brokerage clients and lower average rates from fully disclosed clients. Retail commissions decreased 12.1% to \$107.5 million in the 2006 period from \$122.4 million in the 2005 period due to the business shifting some accounts from a commission to fee-based structure.

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

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

| (in thousands) | Three Months Ended | | | Nine Months Ended | |
|------------------------------|--------------------|--------------------|------------|--------------------|--------------------|
| | August 31, 2006 | August 31, 2005 | % Increase | August 31, 2006 | August 31, 2005 |
| Fixed income | \$ 789,335 | \$ 694,812 | 13.6% | \$2,655,894 | \$2,242,740 |
| Equities | 304,662 | 188,330 | 61.8% | 1,081,013 | 599,214 |
| Total principal transactions | \$1,093,997 | \$ 883,142 | 23.9% | \$3,736,907 | \$2,841,954 |

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

Revenues from principal transactions increased 23.9% to \$1.09 billion for the 2006 quarter from \$883.1 million for the 2005 quarter. Fixed income revenues increased 13.6% to \$789.3 million for the 2006 quarter from \$694.8 million for the 2005 quarter. Net revenues from the Company's credit derivatives area increased, as a result of increased customer volumes. Net revenues from the Company's leveraged finance area also increased. Mortgage-backed securities revenues continued to be strong in the 2006 quarter. While revenues from agency and non-agency mortgage-backed securities were largely unchanged in the 2006 quarter compared with the 2005 quarter, revenues from commercial mortgages and CDO's increased on higher securitization volumes reflecting favorable investor demand and market share gains. Revenues derived from equities activities increased 61.8% to \$304.7 million for the 2006 quarter from \$188.3 million for the 2005 quarter. The 2006 quarter included significant gains on the Company's sale of certain commodity assets. Net revenues from the equity derivatives business area rose as a result of increased customer demand. Net revenues from the Company's international equity sales and trading also rose, reflecting continued strength in European and Asian equities. In addition, net revenues from the risk arbitrage business increased on higher global announced M&A volumes.

Revenues from principal transactions increased 31.5% to \$3.74 billion for the nine months ended August 31, 2006 from \$2.84 billion for the comparable prior year period. Fixed income revenues increased 18.4% to \$2.66 billion for the 2006 period from \$2.24 billion for the comparable prior year period. Mortgage-backed

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securities revenues increased in the 2006 period when compared to the 2005 period on higher origination volumes from asset-backed securities and adjustable rate mortgage ("ARM") securities and increased secondary trading revenues, particularly in non-agency mortgage-backed securities and ARMS. Net revenues from distressed trading also contributed to the increase in fixed income revenues as corporate credit spreads tightened during the 2006 period. Additionally, credit derivatives net revenues rose on increased customer activities reflecting favorable market conditions. Revenues derived from equities activities increased 80.4% to \$1.08 billion for the 2006 period from \$599.2 million for the 2005 period. The 2006 period also included gains on the Company's sale of certain commodity assets as well as gains on the Company's investment in NYSE Group Inc. Net revenues from equity derivatives rose on increased customer activity. Net revenues from the Company's international equity sales and trading area also rose, reflecting higher trading volumes as well as market share gains in both European and Asian equities. In addition, net revenues from the risk arbitrage business increased on higher global announced M&A volumes.

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

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

| (in thousands) | Three Months Ended | | | Nine Months Ended | | |
|---------------------------------|--------------------|--------------------|---------------------------|--------------------|--------------------|---|
| | August 31, 2006 | August 31, 2005 | % Increase/ (Decrease) | August 31, 2006 | August 31, 2005 | % |
| Underwriting | \$ 86,280 | \$ 114,509 | (24.7%) | \$ 349,779 | \$ 366,547 | |
| Advisory and other fees | 187,334 | 108,290 | 73.0% | 512,881 | 285,639 | |
| Merchant banking | 9,893 | 93,098 | (89.4%) | 76,850 | 147,847 | |
| Total investment banking | \$ 283,507 | \$ 315,897 | (10.3%) | \$ 939,510 | \$ 800,033 | |

Investment banking revenues decreased 10.3% to \$283.5 million for the 2006 quarter from \$315.9 million for the 2005 quarter. Underwriting revenues decreased 24.7% to \$86.3 million for the 2006 quarter from \$114.5 million for the 2005 quarter. Equity underwriting revenues decreased as lower levels of equity underwriting activity reflected a less favorable market environment. Advisory and other fees increased 73.0% to \$187.3 million for the 2006 quarter from \$108.3 million for the 2005 quarter, reflecting an increase in completed M&A assignments. In addition, mortgage servicing revenues increased during the 2006 quarter, reflecting growth in loan servicing volumes. Merchant banking revenues, which include realized and unrealized investment gains and performance fees on managed merchant banking funds, decreased 89.4% to \$9.9 million for the 2006 quarter from \$93.1 million for the 2005 quarter, reflecting lower net gains on the Company's portfolio of investments and lower performance fees on managed merchant banking funds.

Investment banking revenues increased 17.4% to \$939.5 million for the nine months ended August 31, 2006 from \$800.0 million for the nine months ended August 31, 2005. Underwriting revenues decreased 4.6% to \$349.8 million for the 2006 period from \$366.5 million for the 2005 period, primarily due to lower

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levels of equity underwriting activity. Advisory and other fees increased 80.0% to \$512.9 million for the 2006 period from \$285.6 million for the 2005 period, reflecting a significant increase in completed M&A assignments as well as an increase in mortgage servicing fees. Merchant banking revenues decreased 48.0% to \$76.9 million for the 2006 period from \$147.8 million for the 2005 period, reflecting lower net gains on the Company's portfolio of investments and lower performance fees on managed merchant banking funds.

Net interest revenues (interest and dividend revenue less interest expense) increased 37.0% to \$316.4 million for the 2006 quarter from \$231.0 million for the 2005 quarter. The increase in net interest revenues was primarily attributable to higher average customer margin and short sale balances and improved net interest margins and asset liability composition. Average customer margin debt balances increased 8.5% to \$68.8 billion for the 2006 quarter from \$63.4 billion for the 2005 quarter. Average customer short balances increased 1.0% to \$82.1 billion for the 2006 quarter from \$81.3 billion for the 2005 quarter and average securities borrowed balances decreased 2.5% to \$54.7 billion for the 2006 quarter from \$56.1 billion for the 2005 quarter.

Net interest revenues increased 25.9% to \$893.8 million for the nine months ended August 31, 2006 from \$709.6 million for the nine months ended August 31, 2005. The increase in net interest revenues was primarily attributable to improved net interest margins. Average customer margin debt balances increased 4.5% to \$67.2 billion for the 2006 period from \$64.4 billion for the 2005 period. Average customer short balances decreased 8.5% to \$80.2 billion for the 2006 period from \$87.7 billion for the 2005 period and average securities borrowed balances decreased 15.7% to \$54.1 billion for the 2006 period from \$64.3 billion for the 2005 period.

Asset management and other revenues increased 69.6% to \$155.2 million for the 2006 quarter from \$91.5 million for the 2005 quarter. Asset management and other revenues increased 37.8% to \$372.2 million for the nine months ended August 31, 2006 from \$270.1 million for the nine months ended August 31, 2005. These increases were due to increased performance fees on proprietary hedge fund products and increased management fees on traditional assets under management. Private client services net revenues also increased due to higher levels of fee-based assets.

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

Non-Interest Expenses

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

| (in thousands) | Three Months Ended | | | |
|--|--------------------|--------------------|---------------------------|--------------------|
| | August 31, 2006 | August 31, 2005 | % Increase/ (Decrease) | August 31, 2006 |
| Employee compensation and benefits | \$1,024,748 | \$ 850,985 | 20.4% | \$3,291,8 |
| Floor brokerage, exchange and clearance fees | 58,621 | 55,029 | 6.5% | 168,4 |
| Communications and technology | 126,938 | 97,668 | 30.0% | 349,1 |
| Occupancy | 52,976 | 43,354 | 22.2% | 143,0 |
| Advertising and market development | 38,243 | 32,784 | 16.7% | 108,0 |
| Professional fees | 78,110 | 60,018 | 30.1% | 197,4 |

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| | | | | |
|-----------------------------|-------------|-------------|---------|-----------|
| Other expenses | 82,261 | 92,287 | (10.9%) | 302,0 |
| ----- | ----- | ----- | ----- | ----- |
| Total non-interest expenses | \$1,461,897 | \$1,232,125 | 18.6% | \$4,559,9 |
| ===== | ===== | ===== | ===== | ===== |

Employee compensation and benefits includes the cost of salaries, benefits and incentive compensation, including CAP units, restricted stock units and option awards. Employee compensation and benefits increased 20.4% to \$1.02 billion for the 2006 quarter from \$851.0 million for the 2005 quarter, and increased 22.8% to \$3.29 billion for the nine months ended August 31, 2006 from \$2.68 billion for the nine months ended August 31, 2005, primarily due to higher discretionary compensation associated with the increase in net revenues. Employee compensation and benefits as a percentage of net revenues increased to 48.1% for the 2006 quarter from 47.0% for the 2005 quarter, and decreased to 48.3% for the nine months ended August 31, 2006 from 48.5% for the nine months ended August 31, 2005. Full-time employees increased to 13,134 at August 31, 2006 from 11,498 at August 31, 2005. The growth in headcount is primarily due to the expansion of the Company's fixed income, wealth management, global clearing and derivatives areas, resulting from increased business activities and growth initiatives.

Non-compensation expenses increased 14.7% to \$437.1 million for the 2006 quarter from \$381.1 million for the 2005 quarter and increased 3.8% to \$1.27 billion for the nine months ended August 31, 2006 from \$1.22 billion for the nine months ended August 31, 2005. Non-compensation expenses as a percentage of net revenues decreased to 20.5% for the 2006 quarter compared with 21.0% for the 2005 quarter, and decreased to 18.6% for the nine months ended August 31, 2006 compared with 22.1% for the nine months ended August 31, 2005. Communications and technology costs increased 30.0% and 17.6% for the three and nine months ended August 31, 2006, respectively, compared with the corresponding prior year periods, as increased headcount resulted in higher voice and market data-related costs. Occupancy costs increased 22.2% and 15.6% for the three and nine months ended August 31, 2006, respectively, compared with the corresponding prior year periods, reflecting additional office space requirements and higher leasing costs associated with the Company's headquarters building at 383 Madison Avenue in New York City. Professional fees increased 30.1% and 17.5% for the three and nine months ended August 31, 2006, respectively, compared with the corresponding prior year periods, due to higher levels of temporary help and consulting fees. Other expenses decreased 10.9% and 17.8% for the three and nine months ended August 31, 2006, respectively, compared with the corresponding prior year periods. CAP Plan related costs decreased 25.3% to \$29.5 million for the 2006 quarter from \$39.5 million in the 2005 quarter, and decreased 0.9% to \$108.0 million for the nine months ended August 31, 2006 from \$109.0 million for the nine months ended August 31, 2005, due to fewer CAP units outstanding, partially offset by higher levels of earnings, particularly in the current nine month period. The decrease in other expenses for the nine months ended August 31, 2006 reflects a reduction in litigation related costs. Pre-tax profit margin was 31.3% and 33.1% for the three and nine months ended August 31, 2006, respectively, versus 32.0% and 29.3% for the corresponding prior year periods.

The Company's effective tax rate decreased to 34.4% for the 2006 quarter from 34.8% for the 2005 quarter. The Company's effective tax rate for the nine months ended August 31, 2006 decreased to 33.8% from 34.9% for the nine months ended August 31, 2005. During the nine month period ended August 31, 2006, the Company experienced favorable audit settlements which resulted in a reduction in the consolidated effective tax rate.

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Business Segments

The remainder of "Results of Operations" is presented on a business segment basis. The Company's three business segments--Capital Markets, Global Clearing Services and Wealth Management--are analyzed separately due to the distinct nature of the products they provide and the clients they serve. Certain Capital Markets products are distributed by the Wealth Management and Global Clearing Services distribution networks, with the related revenues of such intersegment services allocated to the respective segments.

The following segment operating results exclude certain unallocated revenues (predominantly interest) as well as certain corporate administrative functions, such as certain legal costs and costs related to the CAP Plan. See Note 12, "Segment Data" in the Notes to Condensed Consolidated Financial Statements for complete segment information.

Capital Markets

| (in thousands) | Three Months Ended | | | Nine Months Ended | | |
|------------------------|--------------------|--------------------|---------------------------|--------------------|--------------------|---|
| | August 31, 2006 | August 31, 2005 | % Increase/ (Decrease) | August 31, 2006 | August 31, 2005 | % |
| Net revenues | | | | | | |
| Institutional equities | \$ 435,543 | \$ 333,620 | 30.6% | \$1,478,506 | \$1,037,013 | |
| Fixed income | 877,910 | 739,242 | 18.8% | 2,933,956 | 2,412,762 | |
| Investment banking | 232,253 | 299,935 | (22.6%) | 807,252 | 749,264 | |
| Total net revenues | \$1,545,706 | \$1,372,797 | 12.6% | \$5,219,714 | \$4,199,039 | |
| Pre-tax income | \$ 499,824 | \$ 492,155 | 1.6% | \$1,836,580 | \$1,429,614 | |

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

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

Net revenues for Capital Markets increased 12.6% to \$1.55 billion for the 2006 quarter compared to \$1.37 billion for the 2005 quarter. Pre-tax income for Capital Markets increased 1.6% to \$499.8 million for the 2006 quarter from

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\$492.2 million for the 2005 quarter.

Institutional equities net revenues increased 30.6% to \$435.5 million for the 2006 quarter from \$333.6 million for the 2005 quarter. The 2006 quarter included significant gains from the sale of certain commodity assets. Equity derivatives net revenues increased on improved market conditions and increased customer volumes. Net revenues from the Company's international equity sales and trading also rose, reflecting continued strength in European and Asian equities and risk arbitrage revenues increased on higher announced M&A volumes.

Fixed income net revenues increased 18.8% to \$877.9 million for the 2006 quarter from \$739.2 million for the 2005 quarter. Record level results from the Company's credit derivatives business resulting from increased customer volumes contributed to the increase in fixed income net revenues. Net revenues from the leveraged finance area also increased on higher levels of acquisition related finance activities. Mortgage-backed securities revenues increased in the 2006 quarter when compared to the 2005 quarter despite

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

the 175 basis point increase in short-term rates and significant flattening of the yield curve. Commercial mortgage and CDO net revenues increased as securitization volumes rose on favorable investor demand and market share gains. For the quarter ended August 31, 2006, Bear Stearns ranked as the #1 underwriter of US mortgage-backed securities.

Investment banking revenues decreased 22.6% to \$232.3 million for the 2006 quarter from \$299.9 million for the 2005 quarter. Underwriting revenues decreased 24.4% to \$92.7 million for the 2006 quarter from \$122.6 million for the 2005 quarter, as equity underwriting revenues decreased, reflecting a decrease in the volume of IPO's and follow-on offerings. Advisory and other fees increased 53.9% to \$129.7 million for the 2006 quarter from \$84.2 million for the 2005 quarter, reflecting a significant increase in completed M&A assignments. Merchant banking revenues decreased to \$9.9 million in the 2006 quarter from \$93.1 million during the 2005 quarter. Merchant banking revenues include realized and unrealized investment gains and performance fees on managed merchant banking funds. The decrease in merchant banking revenues was due to lower net gains on the Company's portfolio of investments and lower performance fees on managed merchant banking funds.

Net revenues for Capital Markets increased 24.3% to \$5.22 billion for the nine months ended August 31, 2006 compared to \$4.20 billion for the nine months ended August 31, 2005. Pre-tax income for Capital Markets increased 28.5% to \$1.84 billion for the 2006 period from \$1.43 billion for the 2005 period. Pre-tax profit margin was 35.2% for the 2006 period compared with 34.0% for the 2005 period.

Institutional equities net revenues increased 42.6% to \$1.48 billion for the 2006 period from \$1.04 billion for the 2005 period. Equity derivatives net revenues increased due to increased customer activity resulting from rising equity markets. Net revenues from the Company's international equity sales and trading area also rose, reflecting higher trading volumes as well as higher volatility and strong international M&A activity. In addition, revenues from the Company's energy and commodity activities increased, reflecting gains from the sale of certain commodity assets and increased revenues from the Company's energy activities. The 2006 period also included gains on the Company's investment in NYSE Group Inc.

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Fixed income net revenues increased 21.6% to \$2.93 billion for the 2006 period from \$2.41 billion for the 2005 period. Mortgage-backed securities revenues increased on higher origination volumes and active secondary trading markets. Net revenues from asset-backed securities and ARMS increased, reflecting increased securitization activity and generally tighter mortgage spreads. The Company also achieved strong results from its credit derivatives and leveraged finance areas.

Investment banking revenues increased 7.7% to \$807.3 million for the 2006 period from \$749.3 million for the 2005 period. Underwriting revenues decreased 3.6% to \$378.1 million for the 2006 period from \$392.4 million for the 2005 period as equity underwriting revenues decreased, reflecting lower industry new issue volume. Advisory and other fees for the 2006 period increased 68.5% to \$352.3 million from \$209.0 million for the 2005 period, reflecting increased M&A fees due to a significant increase in completed M&A assignments. Merchant banking revenues decreased to \$76.9 million in the 2006 period from \$147.9 million during the 2005 period, attributable to a decrease in net gains from the Company's principal investments and a decrease in performance fees on merchant banking funds.

Global Clearing Services

| (in thousands) | Three Months Ended | | | Nine Months Ended | | |
|----------------|--------------------|--------------------|---------------------------|--------------------|--------------------|---|
| | August 31, 2006 | August 31, 2005 | % Increase/ (Decrease) | August 31, 2006 | August 31, 2005 | % |
| Net revenues | \$ 269,351 | \$ 258,042 | 4.4% | \$ 822,866 | \$ 804,594 | (|
| Pre-tax income | \$ 113,968 | \$ 127,486 | (10.6%) | \$ 382,585 | \$ 408,249 |) |

The Global Clearing Services segment provides execution, clearing, margin lending and securities borrowing to facilitate customer short sales to clearing clients worldwide. Prime brokerage clients include hedge funds and clients of money managers, short sellers, arbitrageurs and other professional investors. Fully disclosed clients engage in either the retail or institutional brokerage business. At August 31, 2006 and August 31, 2005, the Company held approximately \$282.0 billion and \$255.6 billion, respectively, in equity in Global Clearing Services client accounts.

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Net revenues for Global Clearing Services increased 4.4% to \$269.4 million for the 2006 quarter from \$258.0 million for the 2005 quarter. Net interest revenues increased 6.9% to \$205.7 million for the 2006 quarter from \$192.5 million for the 2005 quarter, reflecting an increase in average customer margin and short sale balances from clearance clients. These results were partially offset by a decline in commission and other revenues of 2.9% to \$63.7 million for the 2006 quarter from \$65.5 million for the 2005 quarter, reflecting lower volumes and average rates from prime brokerage clients and lower average rates from fully disclosed clients. Pre-tax income decreased 10.6% to \$114.0 million, from \$127.5 million for the 2005 quarter. Pre-tax profit margin was 42.3% for the 2006 quarter compared to 49.4% for the 2005 quarter.

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Net revenues for Global Clearing Services increased 2.3% to \$822.9 million for the nine months ended August 31, 2006 from \$804.6 million for the nine months ended August 31, 2005. Net interest revenues increased 5.0% to \$616.3 million for the 2006 period from \$586.6 million for the 2005 period, primarily due to an increase in average customer margin balances. Commission and other revenues decreased 7.5% to \$201.6 million for the 2006 period from \$218.0 million for the 2005 period, reflecting lower volumes and average rates from prime brokerage clients and lower average rates from fully disclosed clients. Pre-tax income decreased 6.3% to \$382.6 million, from \$408.2 million for the 2005 period. Pre-tax profit margin was 46.5% for the 2006 period compared to 50.7% for the 2005 period.

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

| (in billions) | Three Months ended | | Nine Months ended | |
|---|--------------------|--------------------|--------------------|----------------|
| | August 31, 2006 | August 31, 2005 | August 31, 2006 | August 2005 |
| Margin debt balances, average for period | \$ 68.8 | \$ 63.4 | \$ 67.2 | \$ 68.9 |
| Margin debt balances, at period end | 68.9 | 65.9 | 68.9 | 68.9 |
| Customer short balances, average for period | 82.1 | 81.3 | 80.2 | 80.2 |
| Customer short balances, at period end | 85.6 | 80.6 | 85.6 | 85.6 |
| Securities borrowed, average for period | 54.7 | 56.1 | 54.1 | 54.1 |
| Securities borrowed, at period end | 53.1 | 50.0 | 53.1 | 53.1 |
| Free credit balances, average for period | 35.9 | 28.6 | 32.2 | 32.2 |
| Free credit balances, at period end | 36.5 | 29.6 | 36.5 | 36.5 |
| Equity held in client accounts, at period end | 282.0 | 255.6 | 282.0 | 282.0 |

Wealth Management

| (in thousands) | Three Months Ended | | | |
|--|--------------------|--------------------|---------------------------|----------------|
| | August 31, 2006 | August 31, 2005 | % Increase/ (Decrease) | August 2005 |
| Private client services revenues | \$ 148,404 | \$ 138,987 | 6.8% | \$ 138,987 |
| Revenue transferred to Capital Markets segment | (21,100) | (25,090) | (15.9%) | (25,090) |
| Private client services net revenues | 127,304 | 113,897 | 11.8% | 113,897 |
| Asset management | 104,040 | 55,686 | 86.8% | 55,686 |
| Total net revenues | \$ 231,344 | \$ 169,583 | 36.4% | \$ 169,583 |
| Pre-tax income | \$ 20,737 | \$ 4,894 | 323.7% | \$ 4,894 |

The Wealth Management segment is composed of the PCS and asset management areas. PCS provides high-net-worth individuals with an institutional level of

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investment service, including access to the Company's resources and professionals. At August 31, 2006, PCS had approximately 500 account executives in its principal office, six regional offices and two international offices. Asset management manages equity, fixed income and alternative assets for corporate pension plans, public systems, endowments, foundations, multi-employer plans, insurance companies, corporations, families and high-net-worth individuals in the US and abroad.

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

Net revenues for Wealth Management increased 36.4% to \$231.3 million for the 2006 quarter from \$169.6 million for the 2005 quarter. PCS revenues increased 11.8% to \$127.3 million for the 2006 quarter from \$113.9 million for the 2005 quarter, reflecting higher levels of fee-based income attributable to the Company's private client advisory services products. Asset management revenues increased 86.8% to \$104.0 million for the 2006 quarter from \$55.7 million for the 2005 quarter, primarily reflecting increased performance fees on proprietary hedge fund products and increased management fees across all product lines resulting from the growth in assets under management.

Net revenues for Wealth Management increased 22.5% to \$605.7 million for the nine months ended August 31, 2006 from \$494.6 million for the nine months ended August 31, 2005. PCS revenues increased 15.5% to \$385.0 million for the 2006 period from \$333.4 million for the 2005 period, reflecting higher levels of fee-based income attributable to the Company's private client advisory services products. Asset management revenues increased 37.0% to \$220.7 million for the 2006 period from \$161.1 million for the 2005 period, reflecting increased management fees resulting from growth in assets under management and increased performance fees on proprietary hedge fund products.

Assets under management were \$50.2 billion at August 31, 2006, reflecting a 24.5% increase from \$40.3 billion in assets under management at August 31, 2005. The increase in assets under management reflects continued growth in traditional assets attributable to market appreciation and net inflows. Assets under management at August 31, 2006 include \$7.4 billion of assets from alternative investment products, an increase from \$6.1 billion at August 31, 2005.

LIQUIDITY AND CAPITAL RESOURCES

Financial Leverage

Asset Composition

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

Collateralized receivables consist of resale agreements secured predominantly by US government and agency securities, customer margin loans and securities borrowed, which are typically secured by marketable corporate debt and equity securities. The nature of the Company's business as a securities dealer requires it to carry significant levels of securities inventories to meet its customer

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and proprietary trading needs. Additionally, the Company's role as a financial intermediary for customer activities, which it conducts on a principal basis, together with its customer-related activities in its clearance business, results in significant levels of customer-related balances, including customer margin debt, securities borrowed and repurchase activity. The Company's total assets and financial leverage can and do fluctuate, depending largely on economic and market conditions, volume of activity and customer demand.

The Company's total assets at August 31, 2006 increased to \$334.8 billion from \$292.6 billion at November 30, 2005. The increase was primarily attributable to increases in securities borrowed, securities received as collateral, financial instruments owned, at fair value and assets of variable interest entities and mortgage loan special purpose entities, partially offset by decreases in securities purchased under agreements to resell and customer receivables. The Company's total capital base, which consists of long-term debt, preferred equity issued by subsidiaries and total stockholders' equity, increased to \$61.9 billion at August 31, 2006 from \$54.3 billion at November 30, 2005. This change was primarily due to a net increase in long-term debt and an increase in stockholders' equity due to earnings as well as income tax benefits attributable to the distribution of common stock under the Company's deferred compensation plans.

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

The Company's total capital base as of August 31, 2006 and November 30, 2005 was as follows:

| (in millions) | August 31, 2006 | November 30, 2005 |
|--------------------------------|--------------------|----------------------|
| <hr/> | | |
| Long-term borrowings: | | |
| Senior debt | \$ 49,938 | \$ 43,227 |
| Subordinated debt (1) | 263 | 263 |
| <hr/> | | |
| Total long-term borrowings | \$ 50,201 | \$ 43,490 |
| Stockholders' equity: | | |
| Preferred stockholders' equity | \$ 359 | \$ 372 |
| Common stockholders' equity | 11,363 | 10,419 |
| <hr/> | | |
| Total stockholders' equity | \$ 11,722 | \$ 10,791 |
| <hr/> | | |
| Total capital | \$ 61,923 | \$ 54,281 |
| <hr/> | | |

(1) Represents junior subordinated deferrable interest debentures issued by the Company, held by Bear Stearns Capital Trust III.

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

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critical determinants of both total capital and the equity portion thereof, thus significantly influencing the amount of leverage that the Company can employ.

Given the nature of the Company's market-making and customer-financing activity, the overall size of the balance sheet fluctuates from time to time. The Company's total assets at quarter end are lower than would be observed on an average basis. At the end of each quarter, the Company typically uses excess cash to finance high-quality, highly liquid securities inventory that otherwise would be funded via the repurchase agreement market. In addition, the Company reduces its matched book repurchase and reverse repurchase activities at quarter end. Finally, the Company may reduce the aggregate level of inventories through ordinary course, open market activities in the most liquid portions of the balance sheet, which are principally US government and agency securities and agency mortgage pass-through securities. At August 31, 2006 and November 30, 2005, total assets of \$334.8 billion and \$292.6 billion were approximately 1.8% and 5.6%, respectively, lower than the average of the month-end balances observed over the trailing 12-month period. Despite reduced total assets at quarter end, the Company's overall market, credit and liquidity risk profile does not change materially, since the reduction in asset balances is predominantly in highly liquid, short-term instruments that are financed on a secured basis. This periodic reduction verifies the inherently liquid nature of the balance sheet and provides consistency with respect to creditor constituents' evaluation of the Company's financial condition.

Leverage Ratios

Balance sheet leverage measures are one approach to assessing the capital adequacy of securities firms. The following table presents total assets and net adjusted assets with the resultant leverage ratios at August 31, 2006 and November 30, 2005. Gross leverage equals total assets divided by stockholders' equity, inclusive of preferred and trust preferred equity. The Company views its trust preferred equity as a component of its equity capital base given the equity-like characteristics of the securities. The Company also receives rating agency equity credit for these securities. Net adjusted leverage equals net adjusted assets divided by tangible equity capital, which excludes goodwill and intangible assets from both the numerator and denominator, as equity used to support goodwill and intangible assets is not available to support the balance of the Company's net assets. With respect to a comparative measure of financial risk and capital adequacy, the Company believes that the low-risk, collateralized nature of its securities purchased under agreements to resell, securities borrowed, securities received as collateral, customer receivables and segregated cash assets renders net adjusted leverage as the relevant measure.

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

| (in millions, except ratios) | August 31, 2006 | November 30, 2005 |
|---|--------------------|----------------------|
| <hr style="border-top: 1px dashed black;"/> | | |
| Total assets | \$ 334,760 | \$ 292,635 |
| Deduct: | | |
| Cash and securities deposited with clearing organizations or segregated in compliance with federal regulations | 8,845 | 5,270 |
| Securities purchased under agreements to resell | 40,457 | 42,648 |
| Securities received as collateral | 17,480 | 12,426 |

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| | | |
|--|------------|------------|
| Securities borrowed | 73,960 | 62,915 |
| Receivables from customers | 29,970 | 33,255 |
| Goodwill & intangible assets | 381 | 355 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Subtotal | 163,667 | 135,766 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Add: | | |
| Financial instruments sold, but not yet purchased | 41,059 | 35,004 |
| Deduct: | | |
| Derivative financial instruments | 12,720 | 12,957 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Net adjusted assets | \$ 192,006 | \$ 157,813 |
| <hr style="border-top: 3px double black;"/> | | |
| Stockholders' equity | | |
| Common equity | \$ 11,363 | \$ 10,419 |
| Preferred stock | 359 | 372 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Total stockholders' equity | 11,722 | 10,791 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Add: | | |
| Trust preferred equity | 263 | 263 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Subtotal - leverage equity | 11,985 | 11,054 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Deduct: | | |
| Goodwill & intangible assets | 381 | 355 |
| <hr style="border-top: 1px dashed black;"/> | | |
| Tangible equity capital | \$ 11,604 | \$ 10,699 |
| <hr style="border-top: 3px double black;"/> | | |
| Gross leverage | 27.9 x | 26.5 x |
| Net adjusted leverage | 16.5 x | 14.8 x |
| <hr style="border-top: 1px dashed black;"/> | | |

Funding Strategy & Liquidity Risk Management

General Funding Strategy

Liquidity is extraordinarily important for financial services firms in general and for securities firms in particular, given their reliance on market confidence and funding. Consequently, the Company focuses on management of funding and liquidity risk. The Company's overall objective and general funding strategy seeks to ensure liquidity and diversity of funding sources to meet the Company's financing needs at all times and under all market environments. In financing its balance sheet, the Company maximizes its use of secured funding where economically competitive. Short-term sources of cash consist principally of collateralized borrowings, including repurchase transactions, sell/buy arrangements, securities lending arrangements and customer free credit balances. Short-term unsecured funding sources expose the Company to rollover risk, as providers of credit are not obligated to refinance the instruments at maturity.

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For this reason, the Company prudently manages its reliance on short-term unsecured borrowings by maintaining an adequate total capital base and extensive use of secured funding. In addition to this strategy, the Company places emphasis on diversification by product, geography, maturity and instrument to further ensure prudent, moderate usage of more credit-sensitive, potentially less stable, funding. Short-term unsecured funding sources include commercial paper, bank loans and other borrowings, which generally have maturities ranging from overnight to one year. The Company views its secured funding as inherently less credit sensitive and therefore a more stable source of funding due to the collateralized nature of the borrowing.

In addition to short-term funding sources, the Company utilizes equity and long-term debt, including floating- and fixed-rate notes, as longer-term sources of unsecured financing. The Company regularly monitors and analyzes the size, composition and liquidity characteristics of its asset base in the context of each asset's ability to be used to obtain secured financing. This analysis helps the Company in determining its aggregate need for longer-term funding sources (i.e., long-term debt and

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

equity). The Company views long-term debt as a stable source of funding, which effectively strengthens its overall liquidity profile and mitigates liquidity risk.

Alternative Funding Strategy

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

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

The borrowing value advance rates used in the Company's liquidity ratio calculation and the haircuts incorporated in the cash capital model are symmetrical. These advance rates are considered readily available, even in a

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stressed environment. In the vast majority of circumstances/asset classes, they are derived from committed secured bank facilities, whereby a bank or group of banks are contractually obligated to lend to the Company at a pre-specified advance rate on specific types of collateral regardless of the "market environment." As such, the advance rates/haircuts in the alternative liquidity models are typically worse than those the Company realizes in normalized repo and secured lending markets. The advance rates in the liquidity ratio reflect what can be reliably realized in a stressed liquidity environment. The haircuts used in the cash capital model are consistent with the advance rates in the liquidity ratio in that the haircut is equal to one minus the advance rate.

As of August 31, 2006, the market value of unencumbered, unhypothecated financial instruments owned by the Company was approximately \$47.6 billion with a borrowing value of \$36.0 billion. The assets are composed of primarily mortgage- and asset-backed securities, investment-grade municipal and corporate bonds, US equities, and residential and commercial mortgage whole loans. The average advance rate on these different asset types ranges from 44% to 96% and, as described above, is based predominantly on committed, secured facilities that the Company and its subsidiaries maintain in different regions globally. The liquidity ratio, explained above, based solely on Company owned securities, has averaged 132% over the previous 12 months including unused committed unsecured bank credit, and 124% excluding the unsecured portion of the Company's \$4.0 billion committed revolving credit facility. On this same basis, the liquidity ratio was 137% as of August 31, 2006 and 130% excluding committed unsecured bank credit.

While The Bear Stearns Companies Inc. ("Parent Company") is the primary issuer of unsecured debt in the marketplace, the collateral referred to in the preceding paragraph is held in various subsidiaries, both regulated and unregulated. A subsidiary's legal entity status and the Company's intercompany funding structure may constrain liquidity available to the Parent Company, as regulators may prevent the flow of funds and/or securities from a regulated subsidiary to its parent company or other subsidiaries. In recognition of this potential for liquidity to be trapped in subsidiaries, the Company maintains a minimum \$5.0 billion of liquidity immediately accessible by the Parent Company at all times. This liquidity reserve takes the

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

form of cash deposits and money market instruments that are held at the Parent Company and high-quality collateral (corporate bonds, municipal bonds, equity securities) that is owned by subsidiaries and explicitly pledged to and segregated for the benefit of the Parent Company and maintained at a third-party custodian. For purposes of calculating the aggregate value of the liquidity reserve, the contractually obligated advance rates described herein are used to determine the borrowing value of collateral pledged. In addition to this immediately available liquidity, the Company monitors unrestricted liquidity available to the Parent Company via the ability to monetize unencumbered assets held in unregulated and regulated entities. As of August 31, 2006, approximately \$30.4 billion of the market value identified in the liquidity ratio data above was held in unregulated entities and thus likely to be available to the Parent Company, while an additional \$4.0 billion market value had been pledged to the Parent Company as collateral for inter-company borrowings and was thus readily available. The remaining \$13.2 billion market value of unencumbered securities was held in regulated entities, a portion of which may be available to provide liquidity to the Parent Company.

The cash capital framework is utilized to evaluate the Company's long-term

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

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

At August 31, 2006, the Company's net cash capital position was \$1.4 billion. Fluctuations in net cash capital are common and are a function of variability in total assets, balance sheet composition and total capital. The Company attempts to maintain cash capital sources in excess of the aggregate longer-term funding requirements of the firm (i.e., positive net cash capital). Over the previous 12 months, the Company's net cash capital position has averaged \$2.5 billion.

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

With respect to the management of refinancing risk, the maturity profile of the long-term debt portfolio of the Company is monitored on an ongoing basis and structured within the context of two diversification guidelines. The Company has a general guideline of no more than 20% of its long-term debt portfolio maturing in any one year, as well as no more than 10% maturing in any one quarter over the next five years. As of August 31, 2006, the weighted average maturity of the Company's long-term debt was 4.2 years.

Committed Credit Facilities

The Company has a committed revolving credit facility ("Facility") totaling \$4.0 billion, which permits borrowing on a secured basis by the Parent Company, BSSC,

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BSIL and certain other subsidiaries. The Facility also allows the Parent Company and BSIL to borrow up to \$2.0 billion of the Facility on an unsecured basis. Secured borrowings can be collateralized by both investment-grade and non-investment-grade financial instruments as the Facility provides for defined advance rates on a wide range of financial instruments eligible to be pledged. The Facility contains financial covenants, the

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

most significant of which require maintenance of specified levels of stockholders' equity of the Company and net capital of BSSC. The facility terminates in February 2007, with all loans outstanding at that date payable no later than February 2008. There were no borrowings outstanding under the Facility at August 31, 2006.

The Company has a \$1.50 billion committed revolving securities repo facility ("Repo Facility"), which permits borrowings secured by a broad range of collateral under a repurchase arrangement by the Parent Company, BSIL, Bear Stearns International Trading Limited ("BSIT") and BSB. The Repo Facility contains financial covenants that require, among other things, maintenance of specified levels of stockholders' equity of the Company. The Repo Facility terminates in August 2007, with all repos outstanding at that date payable no later than August 2008. There were no borrowings outstanding under the Repo Facility at August 31, 2006.

The Company has a \$350 million committed revolving credit facility ("Pan Asian Facility"), which permits borrowing on a secured basis by the Parent Company, BSSC and Bear Stearns Japan Limited ("BSJL"). The Pan Asian Facility contains financial covenants that require, among other things, maintenance of specified levels of stockholders' equity of the Company and net capital of BSSC. The Pan Asian Facility terminates in December 2006 with all loans outstanding at that date payable no later than December 2007. There were no borrowings outstanding under the Pan Asian Facility at August 31, 2006.

The Company has a \$350 million committed revolving credit facility ("Tax Lien Facility"), which permits borrowing on a secured basis by the Parent Company, Plymouth Park Tax Services and Madison Tax Capital LLC. The Tax Lien Facility contains financial covenants that require, among other things, maintenance of specified levels of stockholders' equity of the Company. The Tax Lien Facility terminates in March 2007 with all loans outstanding at that date payable no later than March 2008. There were no borrowings outstanding under the Tax Lien Facility at August 31, 2006.

The Company also maintains a series of committed credit facilities, which permit borrowing on a secured basis, to support liquidity needs for the financing of investment-grade and non-investment-grade corporate loans, residential mortgages, commercial mortgages, listed options and whole loans. The facilities are expected to be drawn from time to time and expire at various dates, the longest of such periods ending in fiscal 2007. All of these facilities contain a term-out option of one year or more for borrowings outstanding at expiration. The banks providing these facilities are committed to provide up to an aggregate of approximately \$4.4 billion. At August 31, 2006, the borrowings outstanding under these committed credit facilities were \$167.1 million.

Capital Resources

The Parent Company, operating as the centralized unsecured funding arm of the

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

Within this funding framework, the Company attempts to fund equity investments in subsidiaries with equity from the Parent Company (i.e., utilize no equity double leverage). At August 31, 2006, the Parent Company's equity investment in subsidiaries was \$8.2 billion versus common stockholders' equity and preferred equity of \$11.4 billion and \$359.2 million, respectively. As such, at August 31, 2006, the ratio of the equity investment in subsidiaries to Parent Company equity (equity double leverage) was approximately 0.72 based on common equity and 0.70 including preferred equity. At November 30, 2005, these measures were 0.69 based on common equity and 0.67 including preferred equity. Additionally, all subordinated debt advances to regulated subsidiaries for use as regulatory capital, which totaled \$10.4 billion at August 31, 2006, are funded with long-term debt issued by the Company having a remaining maturity equal to or greater than the maturity of the subordinated debt advance. The Company regularly monitors the nature and significance of assets or activities conducted in all subsidiaries and attempts to

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

fund such assets with both capital and/or borrowings having a maturity profile and relative mix consistent with the nature and self-funding ability of the assets being financed. The funding mix also takes into account regulatory capital requirements for regulated subsidiaries.

Long-term debt totaling \$43.9 billion and \$37.0 billion had remaining maturities beyond one year at August 31, 2006 and November 30, 2005, respectively. The Company accesses funding in a variety of markets in the United States, Europe and Asia. The Company issues debt through syndicated US registered offerings, US registered and 144A medium-term note programs, other US and non-US bond and note offerings and other methods. The Company's access to external sources of financing, as well as the cost of that financing, is dependent on various factors and could be adversely affected by a deterioration of the Company's long- and short-term debt ratings, which are influenced by a number of factors. These factors include, but are not limited to: material changes in operating margins; earnings trends and volatility; the prudence of funding and liquidity management practices; financial leverage on an absolute basis and/or relative to peers; the composition of the balance sheet and/or capital structure; geographic and business diversification; and the Company's market share and competitive position in the business segments in which it operates. Material deterioration in any one or a combination of these factors could result in a downgrade of the Company's credit ratings, thus increasing the cost of and/or limiting the availability of unsecured financing. Additionally, a reduction in the Company's credit ratings could also trigger incremental collateral requirements, predominantly in the over-the-counter derivatives market. As of August 31, 2006,

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a downgrade by either Moody's Investors Service or Standard & Poor's in the Company's long-term credit ratings to the level of A3 or A- would have resulted in the Company needing to post \$56.3 million in additional collateral pursuant to contractual arrangements for outstanding over-the-counter derivatives contracts. A downgrade to Baal or BBB+ would have resulted in needing to post an additional \$334.3 million in collateral.

At August 31, 2006, the Company's long-term/short-term debt ratings were as follows:

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

NR - does not assign a short-term rating

In October 2005, Standard & Poor's Ratings Services changed the outlook on The Bear Stearns Companies Inc. from stable to positive. Simultaneously, the A/A-1 ratings were affirmed. Standard & Poor's cited the outlook change reflects the Company's high profitability with low earnings volatility during the past several years. Standard & Poor's also cited the strength of the Company's various franchises, conservative management team and low tolerance for risk. Standard & Poor's cited the outlook change indicates that the rating could be raised during the next one to two years if the Company continues to perform well.

In June 2006, Japan Credit Rating Agency, Ltd. assigned a rating of AA to The Bear Stearns Companies Inc. senior long-term debt with a stable outlook.

In August 2006, the Japanese-based rating agency Rating & Investment Information, Inc. upgraded the issuer rating of The Bear Stearns Companies Inc. to AA- from A+ with a stable outlook. Rating & Investment Information, Inc. cited the firm's continued dominant market position in the prime brokerage area and successful diversification of the Company's revenue sources in fixed income and institutional equities.

Stock Repurchase Program

The Company has various employee stock compensation plans designed to increase the emphasis on stock-based incentive compensation and align the compensation of its key employees with the long-term interests of stockholders. Such plans provide for annual grants of stock units and stock options. The Company intends to offset the potentially dilutive impact of

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

the annual grants by purchasing common stock throughout the year in open market and private transactions.

The Company has two authorizations to purchase its common stock in fiscal 2006. On December 12, 2005, the Board of Directors of the Company approved an amendment to the Stock Repurchase Program ("Repurchase Program") to replenish

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the previous authorization to allow the Company to purchase up to \$1.5 billion of common stock in fiscal 2006 and beyond. During the quarter ended August 31, 2006, the Company purchased under the current authorization a total of 2,947,682 shares at a cost of approximately \$401.1 million. The Company may, depending upon price and other factors, acquire additional shares in excess of that required for annual share awards. Approximately \$648.8 million was available to be purchased under the current authorization as of August 31, 2006.

Under the second stock repurchase authorization, during the quarter ended August 31, 2006, the Company purchased a total of 380,791 shares of its common stock at a total cost of \$52.0 million pursuant to a \$200 million CAP Plan Earnings Purchase Authorization, which was approved by the Compensation Committee of the Board of Directors of the Company on December 9, 2005. Approximately \$68.5 million was available to be purchased under the current authorization as of August 31, 2006.

On September 5, 2006, the Company entered into a series of forward contracts pursuant to the CAP Plan with a number of CAP Plan participants. Under these forward contracts such participants have agreed to sell up to 1,006,613 common shares of the Company's common stock that are due to be distributed on or about November 30, 2006. The forward contracts will settle on November 30, 2006. The purchase price will be based on the daily volume weighted average price of the common stock of the Company as reported on the NYSE on each day that the weighted average price is between \$122 and \$152 per share during the 61 business day period from September 5, 2006 through November 29, 2006, less \$.05 per share. The shares will be purchased pursuant to the Repurchase Program.

Cash Flows

Cash and cash equivalents decreased \$1.13 billion to \$4.73 billion at August 31, 2006 from \$5.86 billion at November 30, 2005. Cash used in operating activities was \$12.5 billion, primarily attributable to increases in financial instruments owned and securities borrowed, net of securities loaned, partially offset by a decrease in net receivables from customers and an increase in financial instruments sold, but not yet purchased, which occurred in the normal course of business as a result of changes in customer needs, market conditions and trading strategies. Cash used in investing activities of \$144.1 million reflected purchases of property, equipment and leasehold improvements. Cash provided by financing activities of \$11.5 billion reflected proceeds from the issuance of long-term borrowings of \$13.4 billion and net proceeds relating to short-term borrowings of \$5.8 billion, primarily to fund normal operating activities. This was partially offset by payments for the retirement/repurchase of long-term borrowings of \$7.6 billion. Treasury stock purchases of \$982.7 million were made to provide for the annual grant of CAP Plan units, restricted stock units and stock options.

Regulated Subsidiaries

Effective December 1, 2005, the Company became regulated by the Securities and Exchange Commission ("SEC") as a consolidated supervised entity ("CSE"). As a CSE, the Company is subject to group-wide supervision and examination by the SEC and is required to compute allowable capital and allowances for market, credit and operational risk on a consolidated basis. As of August 31, 2006, the Company was in compliance with the CSE capital requirements.

As registered broker-dealers and futures commission merchants, Bear Stearns and BSSC are subject to the net capital requirements of the Exchange Act and Rule 1.17 under the Commodity Futures Trading Commission. Effective December 1, 2005 the SEC approved Bear Stearns' use of Appendix E of the Net Capital Rule which establishes alternative net capital requirements for broker-dealers that are

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part of consolidated supervised entities. Appendix E allows Bear Stearns to calculate net capital charges for market risk and derivatives-related credit risk based on mathematical models provided that Bear Stearns holds tentative net capital in excess of \$1 billion and net capital in excess of \$500 million. BSIL and BSIT, the Company's London-based broker-dealer subsidiaries, are subject to the regulatory capital requirements of the U.K.'s Financial Services Authority. Additionally, BSB is subject to the regulatory capital requirements of the Financial Regulator. Custodial Trust Company ("CTC"), a Federal Deposit Insurance Corporation ("FDIC") insured New Jersey state chartered bank, is subject to the capital

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

requirements of the FDIC. At August 31, 2006, Bear Stearns, BSSC, BSIL, BSIT, BSB and CTC were in compliance with their respective regulatory capital requirements. Certain other subsidiaries are subject to various securities regulations and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. At August 31, 2006, these other subsidiaries were in compliance with their applicable local capital adequacy requirements.

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

Merchant Banking and Private Equity Investments

In connection with the Company's merchant banking activities, the Company has investments in merchant banking and private equity-related investment funds as well as direct investments in private equity-related investments. At August 31, 2006, the Company held investments with an aggregate recorded value of approximately \$702.2 million, reflected in the Condensed Consolidated Statements of Financial Condition, primarily in "Other assets." At November 30, 2005, the Company held investments with an aggregate recorded value of approximately \$658.8 million. In addition to these various direct and indirect principal investments, the Company has made commitments to invest in private equity-related investments and partnerships (see the summary table under "Commitments").

High Yield Positions

As part of its fixed income activities, the Company participates in the underwriting and trading of non-investment-grade corporate debt securities and also invests in, syndicates and trades in loans to highly leveraged, below investment-grade rated companies (collectively, "high yield positions"). Non-investment-grade debt securities have been defined as non-investment-grade corporate debt and emerging market debt rated BB+ or lower, or equivalent ratings recognized by credit rating agencies. At August 31, 2006 and November 30, 2005, the Company held high yield positions approximating \$9.9 billion and \$6.7 billion, respectively, substantially all of which are in "Financial instruments owned" in the Condensed Consolidated Statements of Financial Condition, and \$1.9 billion and \$1.7 billion, respectively, reflected in "Financial instruments sold, but not yet purchased" in the Condensed

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Consolidated Statements of Financial Condition. Included in the high yield positions are extensions of credit to highly leveraged companies. At August 31, 2006 and November 30, 2005, the amount outstanding to highly leveraged borrowers totaled \$6.9 billion and \$4.2 billion, respectively. The largest industry concentration was the telecommunications industry, which approximated 19.3% and 17.2% of these highly leveraged borrowers' positions at August 31, 2006 and November 30, 2005, respectively. Additionally, the Company has lending commitments with highly leveraged borrowers (see the summary table under "Commitments").

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

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

Contractual Obligations

In connection with its operating activities, the Company enters into contractual obligations that require future cash payments. At August 31, 2006, the Company's contractual obligations by maturity, excluding derivative financial instruments, were as follows:

| (in millions) | Payments Due By Period | | | |
|---------------------------------------|--------------------------|----------------------|----------------------|-------|
| | Remaining Fiscal 2006 | Fiscal 2007- 2008 | Fiscal 2009- 2010 | There |
| Long-term borrowings (1) (2) | \$ 1,081 | \$ 17,577 | \$ 14,045 | \$ 1 |
| Future minimum lease payments (3) (4) | 20 | 181 | 176 | |

(1) Amounts include fair value adjustments in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133 as well as \$262.5 million of junior subordinated deferrable interest debentures ("Debentures"). The Debentures will mature on May 15, 2031; however, the Company, at its option, may redeem the Debentures beginning May 15, 2006. The Debentures are reflected in the table at their contractual maturity dates.

(2) Included in fiscal 2007 and fiscal 2008 are approximately \$3.2 billion and \$0.1 billion, respectively, of floating-rate notes that are redeemable prior to maturity at the option of the noteholder. These notes contain certain provisions that effectively enable noteholders to put these notes back to the Company and, therefore, are reflected in the table at the date such notes first become redeemable. The final maturity dates of these notes are during fiscal 2009, fiscal 2010 and thereafter.

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- (3) Includes 383 Madison Avenue Headquarters in New York City.
- (4) See Note 10, "Commitments and Contingencies," in the Notes to Condensed Consolidated Financial Statements.

Commitments

The Company has commitments(1) under a variety of commercial arrangements. At August 31, 2006, the Company's commitments associated with lending and financing, private equity-related investments and partnerships, outstanding letters of credit, underwriting and other commercial commitments summarized by period of expiration were as follows:

| (in millions) | Amount of Commitment Expiration Per Pe | | | | Comm wit stated |
|--|--|---------------------|---------------------|------------|-----------------------|
| | Remaining Fiscal 2006 | Fiscal 2007-2008 | Fiscal 2009-2010 | Thereafter | |
| Lending-related commitments: | | | | | |
| Investment-grade (2) | \$ 716 | \$ 819 | \$ 889 | \$ 765 | \$ |
| Non-investment-grade | 309 | 360 | 484 | 1,396 | |
| Contingent commitments | -- | -- | -- | -- | |
| Commitments to invest in private equity-related investments and partnerships (3) | -- | -- | -- | -- | |
| Underwriting commitments | 218 | -- | -- | -- | |
| Commercial and residential loans | 2,013 | 2,773 | 46 | -- | |
| Letters of credit | 4,181 | 752 | -- | 35 | |
| Other commercial commitments | 16 | 82 | -- | -- | |

- (1) See Note 10, "Commitments and Contingencies," in the Notes to Condensed Consolidated Financial Statements.
- (2) In order to mitigate the exposure to investment-grade borrowings, the Company entered into credit default swaps aggregating \$825.0 million at August 31, 2006.
- (3) At August 31, 2006, commitments to invest in private equity-related investments and partnerships aggregated \$729.2 million. These commitments will be funded, if called, through the end of the respective investment periods, the longest of such periods ending in 2017.

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

OFF-BALANCE-SHEET ARRANGEMENTS

In the normal course of business, the Company enters into arrangements with special purpose entities ("SPEs"), also known as variable interest entities ("VIEs"). SPEs are corporations, trusts or partnerships that are established for

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

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

The Company regularly creates or transacts with entities that may be VIEs. These entities are an essential part of its securitization, asset management and structured finance businesses. In addition, the Company purchases and sells instruments that may be variable interests. The Company consolidates those VIEs in which the Company is the primary beneficiary. See Note 5, "Variable Interest Entities and Mortgage Loan Special Purpose Entities," in the Notes to Condensed Consolidated Financial Statements for a complete discussion of the consolidation of VIEs.

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

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

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

DERIVATIVE FINANCIAL INSTRUMENTS

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

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

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

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

As of August 31, 2006 and November 30, 2005, the Company had notional/contract amounts of approximately \$7.47 trillion and \$5.45 trillion, respectively, of derivative financial instruments, of which \$1.26 trillion and \$1.13 trillion, respectively, were listed futures and option contracts. The aggregate notional/contract value of derivative contracts is a reflection of the level of activity and does not represent the amounts that are recorded in the Condensed Consolidated Statements of Financial Condition. The Company's derivative financial instruments outstanding, which are used either to hedge trading positions, modify the interest rate characteristics of its long- and short-term debt, or are part of its derivative dealer activities, are marked to fair value.

The Company's derivatives had a notional weighted average maturity of approximately 4.7 years and 4.1 years at August 31, 2006 and November 30, 2005, respectively. The maturities of notional/contract amounts outstanding for derivative financial instruments as of August 31, 2006 were as follows:

| (in billions) | Less Than One Year | One to Three Years | Three to Five Years | Greater Than Five Years |
|---------------|-----------------------|-----------------------|------------------------|----------------------------|
| ----- | ----- | ----- | ----- | ----- |

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| | | | | |
|--|------------|------------|------------|------------|
| Swap agreements, including options, swaptions, caps, collars and floors | \$ 398.6 | \$ 2,099.7 | \$ 1,215.5 | \$ 2,323.4 |
| Futures contracts | 370.4 | 233.3 | 24.7 | 0.2 |
| Forward contracts | 123.7 | -- | -- | -- |
| Options held | 362.5 | 59.3 | 1.4 | 0.1 |
| Options written | 222.8 | 31.4 | 1.6 | 0.2 |
| ----- | ----- | ----- | ----- | ----- |
| Total | \$ 1,478.0 | \$ 2,423.7 | \$ 1,243.2 | \$ 2,323.9 |
| ===== | ===== | ===== | ===== | ===== |
| Percent of total | 19.8% | 32.5% | 16.6% | 31.1% |
| ===== | ===== | ===== | ===== | ===== |

CRITICAL ACCOUNTING POLICIES

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

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

Valuation of Financial Instruments

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

The Company's financial instruments can be aggregated in three broad categories: (1) those whose fair value is based on quoted market prices or for which the Company has independent external valuations, (2) those whose fair value is determined based on internally developed models or methodologies that employ data that are readily observable from objective sources, and (3) those whose fair value is estimated based on internally developed models or methodologies utilizing significant assumptions or other data that are generally less readily observable from objective sources.

(1) Financial Instruments Valued Based on Quoted Market Prices or for Which the Company Has Independent External Valuations

The Company's valuation policy is to use quoted market prices from securities and derivatives exchanges where they are available and reliable. Financial instruments valued based on quoted market prices are primarily exchange-traded derivatives and listed equities. Financial instruments that are most typically valued using alternative approaches but for which the Company typically receives independent external valuation information include US Treasuries, most mortgage-backed securities and corporate, emerging market, high yield and municipal bonds. Unlike most equities, which tend to be traded on exchanges, the vast majority of fixed income trading (including US Treasuries) occurs in over-the-counter markets, and, accordingly, the Company's valuation policy is

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based on its best estimate of the prices at which these financial instruments trade in those markets. The Company is an active dealer in most of the over-the-counter markets for these financial instruments, and typically has considerable insight into the trading level of financial instruments held in inventory and/or related financial instruments that it uses as a basis for its valuation.

(2) Financial Instruments Whose Fair Value Is Determined Based on Internally Developed Models or Methodologies That Employ Data That Are Readily Observable from Objective Sources

The second broad category consists of financial instruments for which the Company does not receive quoted prices; therefore, models or other methodologies are utilized to value these financial instruments. Such models are primarily industry-standard models that consider various assumptions, including time value, yield curve, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. A degree of subjectivity is required to determine appropriate models or methodologies as well as appropriate underlying assumptions. This subjectivity makes these valuations inherently less reliable than quoted market prices. Financial instruments in this category include non-exchange-traded derivatives such as interest rate swaps, certain mortgage-backed securities and certain other cash instruments. For an indication of the Company's involvement in derivatives, including maturity terms, see the table setting forth notional/contract amounts outstanding in the preceding "Derivative Financial Instruments" section.

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

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

The Company follows Emerging Issues Task Force ("EITF") Statement No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities." This guidance prohibits recognizing profit at the inception of a derivative contract unless the fair value of the

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

derivative is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique that incorporates observable market data.

The Company participates in the underwriting, securitization or trading of non-performing mortgage-related assets, real estate assets and certain

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residuals. In addition, the Company has a portfolio of Chapter 13 and other credit card receivables from individuals. Certain of these high yield positions have limited price observability. In these instances, fair values are determined by statistical analysis of historical cash flows, default probabilities, recovery rates, time value of money and discount rates considered appropriate given the level of risk in the instrument and associated investor yield requirements.

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

At August 31, 2006 and November 30, 2005, the total value of all financial instruments whose fair value is estimated based on internally developed models or methodologies utilizing significant assumptions or other data that are generally less readily observable from objective sources (primarily fixed income cash positions) aggregated approximately \$9.6 billion and \$7.1 billion, respectively, in "Financial instruments owned" and \$5.5 billion and \$3.5 billion, respectively, in "Financial instruments sold, but not yet purchased" in the Condensed Consolidated Statements of Financial Condition.

Controls Over Valuation of Financial Instruments

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

Merchant Banking

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

Equity interests and securities acquired as a result of leveraged acquisition transactions are reflected in the condensed consolidated financial statements at their initial cost until significant transactions or developments indicate that a change in the carrying value of the securities is appropriate. Generally, the carrying values of these securities will be increased only in those instances where market values are readily ascertainable by reference to substantial transactions occurring in the marketplace or quoted market prices. If quoted market prices are not available, or if liquidating the Company's position is reasonably expected to affect market prices, fair value is determined based on

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other relevant factors. Reductions to the carrying value of these securities are made in the event that the Company's estimate of net realizable value has declined below the carrying value. See "Merchant Banking and Private Equity Investments" in Management's Discussion and Analysis for additional details.

Legal, Regulatory and Tax Contingencies

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

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

damages or claims for indeterminate amounts of damages. The Company is also involved in other reviews, investigations and proceedings by governmental and self-regulatory agencies regarding the Company's business, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

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

The Company is subject to the income tax laws of the US, its states and municipalities and those of the foreign jurisdictions in which the Company has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. The Company must make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and must also make estimates about when in the future certain items may affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Company regularly evaluates the likelihood of assessments in each of the taxing jurisdictions resulting from current and subsequent years' examinations and tax reserves are established as appropriate.

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

ACCOUNTING AND REPORTING DEVELOPMENTS

In June 2005, the EITF reached a consensus on 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

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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. This guidance became effective upon ratification by the FASB on June 29, 2005 for all newly formed limited partnerships and for existing limited partnerships for which the partnership agreements have been modified. For all other limited partnerships, the guidance is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005. For newly formed and modified limited partnerships, the adoption of the EITF did not have a material impact on the consolidated financial statements of the Company. For previously existing limited partnerships, the Company does not expect the EITF consensus to have a material impact on the consolidated financial statements of the Company.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments." SFAS No. 155 is an amendment of SFAS No. 133 and SFAS No. 140. SFAS No. 155 permits companies to irrevocably elect, on a deal by deal basis, to apply a fair value remeasurement to any hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation. SFAS No. 155 is effective for the Company on December 1, 2006. The Company does not expect the adoption of SFAS No. 155 to have a material impact on the consolidated financial statements of the Company.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets." SFAS No. 156 amends SFAS No. 140. SFAS No. 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value. For subsequent measurements, SFAS No. 156 permits companies to choose between using an amortization method or a fair value measurement method for reporting purposes. SFAS No. 156 is effective as of the beginning of a company's first fiscal year that begins after September 15, 2006. The Company does not expect the adoption of SFAS No. 156 to have a material impact on the consolidated financial statements of the Company.

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

In April 2006, the FASB issued FASB Staff Position ("FSP") FIN No. 46 (R)-6 "Determining the Variability to Be Considered in Applying Interpretation No. 46(R)." This FSP addresses how a reporting enterprise should determine the variability to be considered in applying FIN No. 46 (R). The variability that is considered affects the determination of (a) whether the entity is a variable interest entity, (b) which interests are variable interests in the entity, and (c) which party, if any, is the primary beneficiary of the VIE. This FSP states that the variability to be considered shall be based on an analysis of the design of the entity. This analysis includes reviewing the nature of the risks in the entity as well as determining the purpose for which the entity was created. This analysis also includes a determination of the variability that the entity was designed to create and pass along to its interest holders. The Company adopted FSP FIN46(R)-6 on September 1, 2006 on a prospective basis to all entities that the Company first becomes involved with and to all entities previously required to be analyzed under FIN No. 46 (R) when a reconsideration event has occurred. The Company does not expect the adoption of FSP FIN46(R)-6 to have a material impact on the consolidated financial statements of the Company.

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty

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in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. FIN 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. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 must be implemented for fiscal years beginning after December 15, 2006. The Company is currently quantifying what impact, if any, the adoption of FIN 48 is expected to have on the consolidated financial statements of the Company.

In September 2006, the FASB issued 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. SFAS No. 157 requires companies to disclose the fair value of its financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined). Additionally, companies are required to provide enhanced disclosure regarding instruments in the level 3 category, including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing whether it will early adopt SFAS No. 157 as of the first quarter of fiscal 2007 as permitted, and is currently evaluating the impact adoption may have on the consolidated financial statements of the Company.

EFFECTS OF INFLATION

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

For a description of the Company's risk management policies, including a discussion of the Company's primary market risk exposures, which include interest rate risk, foreign exchange rate risk and equity price risk, as well as a discussion of the Company's credit risk including how those exposures are managed, refer to the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2005.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Value-at-Risk

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

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

VaR has inherent limitations, including reliance on historical data, which may not accurately predict future market risk, and the quantitative risk information generated is limited by the parameters established in creating the models. There can be no assurance that actual losses occurring on any one day arising from changes in market conditions will not exceed the VaR amounts shown below or that such losses will not occur more than once in 20 trading days. VaR is not likely to accurately predict exposures in markets that exhibit sudden fundamental changes or shifts in market conditions or established trading relationships. Many of the Company's hedging strategies are structured around likely established trading relationships and, consequently, those hedges may not be effective and VaR models may not accurately predict actual results. Furthermore, VaR calculated for a one-day horizon does not fully capture the market risk of positions that cannot be liquidated in a one-day period. However, the Company believes VaR models are an established methodology for the quantification of risk in the financial services industry despite these limitations. VaR is best used in conjunction with other financial disclosures in order to assess the Company's risk profile.

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QUANTITATIVE AND QUALITATIVE DISCLOSURES
ABOUT MARKET RISK

The aggregate VaR presented here is less than the sum of the individual components (i.e., interest rate risk, foreign exchange rate risk, equity risk), due to the benefit of diversification among the risks. Diversification benefit equals the difference between aggregate VaR and the sum of the VaRs for the three risk categories. This benefit arises because the simulated one-day losses for each of the three primary market risk categories occur on different days and because of general diversification benefits introduced when risk is measured across a larger set of specific risk factors than exist in the respective categories; similar diversification benefits also are taken into account across risk factors within each category. The following table illustrates the VaR for each component of market risk as of August 31, 2006, May 31, 2006, February 28, 2006 and November 30, 2005.

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| (in millions) | August 31, 2006 | May 31, 2006 | February 28, 2006 | November 2005 |
|-------------------------|--------------------|-----------------|----------------------|------------------|
| MARKET RISK | | | | |
| Interest rate | \$ 37.7 | \$ 32.5 | \$ 25.6 | \$ 22.0 |
| Currency | 1.4 | 1.0 | 0.4 | 0.3 |
| Equity | 3.9 | 5.4 | 3.4 | 3.4 |
| Diversification benefit | (9.1) | (8.1) | (4.5) | (4.5) |
| Aggregate VaR | \$ 33.9 | \$ 30.8 | \$ 24.9 | \$ 21.6 |

The table below illustrates the high, low and average VaR for each component of market risk and aggregate market risk during the quarters ended August 31, 2006 and May 31, 2006.

| (in millions) | Quarter Ended August 31, 2006 | | | Quarter Ended May 31, 2006 | | |
|---------------|-------------------------------|---------|---------|----------------------------|---------|---------|
| | High | Low | Average | High | Low | Average |
| MARKET RISK | | | | | | |
| Interest rate | \$ 41.3 | \$ 26.4 | \$ 33.6 | \$ 40.6 | \$ 26.5 | \$ 33.6 |
| Currency | 1.7 | 0.1 | 0.8 | 2.4 | 0.0 | 0.7 |
| Equity | 6.6 | 1.5 | 4.1 | 9.3 | 2.5 | 6.2 |
| Aggregate VaR | 37.1 | 22.2 | 29.2 | 44.4 | 24.0 | 33.7 |

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

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

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The following chart represents a summary of the daily principal transactions revenues and reflects a combination of trading revenues, net interest revenues for certain trading areas and other revenues for the quarters ended August 31, 2006 and 2005.

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QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The chart represents a historical summary of the results generated by the Company's trading activities as opposed to the probability approach used by the VaR model. The average daily trading profit was \$16.8 million and \$13.6 million for the quarters ended August 31, 2006 and 2005, respectively. There were four daily trading losses for the quarter ended August 31, 2006 and five daily trading losses for the quarter ended August 31, 2005. Daily trading losses never exceeded the reported average VaR amounts during the fiscal quarters ended August 31, 2006 and 2005. The frequency distribution of the Company's daily net trading revenues reflects the Company's historical ability to manage its exposure to market risk and the diversified nature of its trading activities. Market conditions were favorable for the Company's trading activity in both its quarters ending August 31, 2006 and 2005. Hedging strategies were generally effective as established trading relationships remained substantially intact and volatility tended to be lower than historical norms. No guarantee can be given regarding future net trading revenues or future earnings volatility. However, the Company believes that these results are indicative of its commitment to the management of market trading risk.

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QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

DISTRIBUTION OF DAILY NET TRADING REVENUES

Quarters Ended August 31, 2006 and August 31, 2005

DAILY NET TRADING REVENUES (\$ millions)

NUMBER OF TRADING DAYS

| | August 31, 2006 | | August 31, 2005 |
|----------|-----------------|----------|-----------------|
| | ----- | | ----- |
| (10)+ | 1 | (10)+ | 1 |
| (10)-(5) | 1 | (10)-(5) | 1 |
| (5)-0 | 2 | (5)-0 | 3 |
| 0-5 | 2 | 0-5 | 7 |
| 5-10 | 17 | 5-10 | 14 |
| 10-15 | 15 | 10-15 | 14 |
| 15-20 | 12 | 15-20 | 11 |
| 20-25 | 5 | 20-25 | 4 |
| 25-30 | 3 | 25-30 | 6 |
| 30+ | 7 | 30+ | 4 |
| | ----- | | ----- |
| Total | 65 | Total | 65 |

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QUANTITATIVE AND QUALITATIVE DISCLOSURES

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ABOUT MARKET RISK

Credit Risk

The Company measures its actual credit exposure (the replacement cost of counterparty contracts) on a daily basis. Master netting agreements, collateral and credit insurance are used to mitigate counterparty credit risk. The credit exposures reflect these risk-reducing features to the extent they are legally enforceable. The Company's net replacement cost of derivative contracts in a gain position at August 31, 2006 and November 30, 2005 approximated \$3.91 billion and \$4.41 billion, respectively. Exchange-traded financial instruments, which typically are guaranteed by a highly rated clearing organization, have margin requirements that substantially mitigate the risk of credit loss.

The following table summarizes the counterparty credit quality of the Company's exposure with respect to over-the-counter derivatives (including foreign exchange and forward-settling mortgage transactions) as of August 31, 2006:

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

| Rating (2) | Exposure | Collateral (3) | Exposure, Net of Collateral (4) | Percentage of Collateral |
|--------------|----------|----------------|---------------------------------|--------------------------|
| AAA | \$ 973 | \$ 16 | \$ 966 | |
| AA | 5,177 | 3,895 | 1,418 | |
| A | 2,643 | 1,827 | 999 | |
| BBB | 364 | 360 | 194 | |
| BB and lower | 1,070 | 2,624 | 261 | |
| Non-rated | 76 | 5 | 76 | |

(1) Excluded are covered transactions structured to ensure that the market values of collateral will at all times equal or exceed the related exposures. The net exposure for these transactions will, under all circumstances, be zero.

(2) Internal counterparty credit ratings, as assigned by the Company's Credit Department, converted to rating agency equivalents.

(3) For lower-rated counterparties, the Company generally receives collateral in excess of the current market value of derivative contracts.

(4) In calculating exposure net of collateral, collateral amounts are limited to the amount of current exposure for each counterparty. Excess collateral is not applied to reduce exposure because such excess in one counterparty portfolio cannot be applied to deficient collateral in a different counterparty portfolio.

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Item 4. CONTROLS AND PROCEDURES

As required by Rule 13a-15(b) of the Exchange Act, the Company's management,

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including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of its disclosure controls and procedures as of the end of the period covered by this quarterly report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) were effective as of the end of the period covered by this quarterly report. As required by Rule 13a-15(d) under the Exchange Act, the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the Company's internal control over financial reporting to determine whether any changes occurred during the quarter covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there have been no such changes during the quarter covered by this quarterly report.

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Part II - OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

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

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

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

Certain legal proceedings in which the Company is involved are discussed in Note 17 to the consolidated financial statements included in the Company's 2005 Financial Report; Part I, Item 3, of the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2005, as amended by Amendment No. 1 thereto on Form 10-K/A (together the "Form 10-K"); and Note 10 to the consolidated financial statements and Part II, Item 1, included in the Company's Form 10-Q for the quarterly periods ended May 31, 2006 and February 28, 2006.

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

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The table below sets forth the information with respect to purchases made by the Company of the Company's common stock during the third quarter of fiscal 2006:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1) |
|------------------|---|---------------------------------------|---|--|
| 6/1/06 - 6/30/06 | 903,683 | \$ 134.00 | 903,683 | \$1,049,259,416 |
| 7/1/06 - 7/31/06 | 1,153,896 | 136.90 | 1,153,896 | 891,296,656 |
| 8/1/06 - 8/31/06 | 1,270,894 | 136.90 | 1,270,894 | 717,305,145 |
| Total | 3,328,473 | | 3,328,473 | |

(1) On December 12, 2005, the Board of Directors of the Company approved an amendment to the Repurchase Program to replenish the previous authorization in order to allow the Company to purchase up to \$1.5 billion of common stock in fiscal 2006 and beyond. The Repurchase Program has no set expiration or termination date. On December 9, 2005, the Compensation Committee of the Board of Directors approved a \$200 million CAP Plan Earnings Purchase Authorization to allow the Company to purchase up to \$200 million of common stock in fiscal 2006.

(2) On September 5, 2006, the Company entered into a series of forward contracts pursuant to the CAP Plan with a number of CAP Plan participants. Under these forward contracts such participants have agreed to sell up to 1,006,613 common shares of the Company's common stock that are due to be distributed on or about November 30, 2006. The forward contracts will settle on November 30, 2006. The purchase price will be based on the daily volume weighted average price of the common stock of the Company as reported on the NYSE on each day that the weighted average price is between \$122 and \$152 per share during the 61 business day period from September 5, 2006 through November 29, 2006, less \$.05 per share. The shares will be purchased pursuant to the Repurchase Program.

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Item 6. EXHIBITS

Exhibits

- (11) Computation of Per Share Earnings. (The calculation of per share earnings is in Note 8, "Earnings Per Share," of Notes to Condensed Consolidated Financial Statements (Earnings Per Share) and is omitted here in accordance with Section (b) (11) of Item 601 of Regulation S-K)
- (12) Computation of Ratio of Earnings to Fixed Charges and to Combined Fixed Charges and Preferred Stock Dividends
- (15) Letter re: Unaudited Interim Financial Information
- (31.1) Certification of Chief Executive Officer Pursuant to Rule

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13a-14(a) or 15d -14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

(31.2) Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

(32.1) Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(32.2) Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

The Bear Stearns Companies Inc.

(Registrant)

Date: October 10, 2006

By: /s/ Jeffrey M. Farber

Jeffrey M. Farber
Controller
(Principal Accounting Officer)

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EXHIBIT INDEX

| Exhibit No. | Description | Page |
|-------------|--|------|
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| (12) | Computation of Ratio of Earnings to Fixed Charges and to Combined Fixed Charges and Preferred Stock Dividends | 67 |
| (15) | Letter re: Unaudited Interim Financial Information | 68 |
| (31.1) | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d -14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | 69 |
| (31.2) | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) | 70 |

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or 15d -14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

- | | | |
|--------|---|----|
| (32.1) | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | 71 |
| (32.2) | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | 72 |