SCHWAB CHARLES CORP
Form 10-Q
May 08, 2007
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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 March 31, 2007

Commission file number 1-9700

THE CHARLES SCHWAB CORPORATION

(Exact name of Registrant as specified in its charter)

Delaware	**94-3025021**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

120 Kearny Street, San Francisco, CA 94108

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (415) 636-7000

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 x 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 x

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

1,249,172,368 shares of $.01 par value Common Stock

Outstanding on April 30, 2007

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THE CHARLES SCHWAB CORPORATION

Quarterly Report on Form 10-Q

For the Quarter Ended March 31, 2007

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Part I - FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statements of Income

(In millions, except per share amounts)

(Unaudited)

	Three Months Ended March 31,	
	2007	**2006**
Net Revenues		
Asset management and administration fees	$ 534	$ 459
Interest revenue	551	489
Interest expense	(167)	(151)
Net interest revenue	384	338
Trading revenue	202	227
Other	33	30
Total net revenues	1,153	1,054
Expenses Excluding Interest		
Compensation and benefits	430	409
Professional services	74	63
Occupancy and equipment	68	62
Advertising and market development	66	49
Communications	49	44
Depreciation and amortization	39	41
Other	36	33
Total expenses excluding interest	762	701
Income from continuing operations before taxes on income	391	353
Taxes on income	(155)	(139)
Income from continuing operations	236	214
Income from discontinued operations, net of tax	37	29
Net Income	$ 273	$ 243

Weighted-Average Common Shares Outstanding Diluted	1,266	1,296
Earnings Per Share - Basic		
Income from continuing operations	$ .19	$ .17
Income from discontinued operations, net of tax	$ .03	$ .02
Net income	$ .22	$ .19
Earnings Per Share - Diluted		
Income from continuing operations	$ .19	$ .17
Income from discontinued operations, net of tax	$ .03	$ .02
Net income	$ .22	$ .19
Dividends Declared Per Common Share	$ .050	$ .025

See Notes to Condensed Consolidated Financial Statements.

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THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Balance Sheets

(In millions, except share and per share amounts)

(Unaudited)

	March 31, 2007	December 31, 2006
Assets		
Cash and cash equivalents	$ 3,257	$ 4,507
Cash and investments segregated and on deposit for federal or other regulatory purposes [(1)] (including resale agreements of $4,583 in 2007 and $4,740 in 2006)	10,542	10,862
Securities owned at market value (including securities pledged of $3 in 2007 and $5 in 2006)	6,812	6,386
Receivables from brokers, dealers, and clearing organizations	694	650
Receivables from brokerage clients net	10,800	10,927
Loans to banking clients net	2,437	2,334
Loans held for sale	44	30
Equipment, office facilities, and property net	606	602
Goodwill	523	419
Deferred tax assets	377	406
Other assets	522	524
Assets retained from discontinued operations	747	749
Assets of discontinued operations	9,917	10,596
Total	$ 47,278	$ 48,992
Liabilities and Stockholders Equity		
Deposits from banking clients	$ 11,443	$ 11,020
Drafts payable	303	324
Payables to brokers, dealers, and clearing organizations	1,745	1,498
Payables to brokerage clients	19,085	20,621
Accrued expenses and other liabilities	1,025	1,069
Long-term debt	387	388
Liabilities of discontinued operations	8,355	9,064
Total liabilities	42,343	43,984
Stockholders equity:		
Preferred stock 9,940,000 shares authorized; $.01 par value per share; none issued		
Common stock 3 billion shares authorized; $.01 par value per share; 1,392,091,544 shares issued	14	14
Additional paid-in capital	1,925	1,868
Retained earnings	5,078	4,901
Treasury stock 139,454,351 and 126,904,699 shares in 2007 and 2006, respectively, at cost	(2,053)	(1,739)
Accumulated other comprehensive loss	(29)	(36)
Total stockholders equity	4,935	5,008

Total	$ 47,278	$ 48,992

(1) Amounts included represent actual balances on deposit, whereas cash and investments required to be segregated for federal or other regulatory purposes at March 31, 2007 and December 31, 2006, excluding $201 million of intercompany repurchase agreements and associated interest, were $9,848 million and $11,063 million, respectively. On April 3, 2007, the Company withdrew a net amount of $324 million of excess segregated cash. On January 3, 2007, the Company deposited a net amount of $554 million into its segregated reserve bank accounts.

See Notes to Condensed Consolidated Financial Statements.

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THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statements of Cash Flows

(In millions)

(Unaudited)

	Three Months Ended March 31,	
	2007	**2006**
Cash Flows from Operating Activities		
Net income	$ 273	$ 243
Adjustments to reconcile net income to net cash provided by operating activities:		
Income from discontinued operations, net of tax	(37)	(29)
Depreciation and amortization	39	41
Stock-based compensation expense	12	9
Excess tax benefits from stock-based compensation	(26)	(24)
Provision for deferred income taxes	35	14
Other	3	4
Originations of loans held for sale	(206)	(165)
Proceeds from sales of loans held for sale	194	148
Net change in:		
Cash and investments segregated and on deposit for federal or other regulatory purposes	320	711
Securities owned (excluding securities available for sale)	9	113
Receivables from brokers, dealers, and clearing organizations	(44)	(17)
Receivables from brokerage clients	125	69
Other assets	4	24
Drafts payable	(21)	(14)
Payables to brokers, dealers, and clearing organizations	247	575
Payables to brokerage clients	(1,536)	(1,251)
Accrued expenses and other liabilities	(69)	(34)
Net change provided by discontinued operations	508	320
Net cash (used for) provided by operating activities	(170)	737
Cash Flows from Investing Activities		
Purchases of securities available for sale	(879)	(1,239)
Proceeds from maturities, calls, and mandatory redemptions of securities available for sale	481	156
Net increase in loans to banking clients	(117)	(106)
Purchase of equipment, office facilities, and property	(39)	(19)
Cash payments for business combinations, net of cash acquired	(117)	
Cash payments for investments, net	(1)	
Net cash provided by (used) for discontinued operations	124	(172)
Net cash used for investing activities	(548)	(1,380)
Cash Flows from Financing Activities		

Net change in deposits from banking clients	423	894
Excess tax benefits from stock-based compensation	26	24
Dividends paid	(63)	(32)
Purchase of treasury stock	(391)	(163)
Proceeds from stock options exercised and other	98	99
Net cash (used for) provided by discontinued operations	(625)	28
Net cash (used for) provided by financing activities	(532)	850
(Decrease) Increase in Cash and Cash Equivalents	(1,250)	207
Cash and Cash Equivalents at Beginning of Period	4,507	1,905
Cash and Cash Equivalents at End of Period	$ 3,257	$ 2,112

See Notes to Condensed Consolidated Financial Statements.

THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

1. Basis of Presentation

The Charles Schwab Corporation (CSC) is a financial holding company engaged, through its subsidiaries, in securities brokerage, banking, and related financial services. Charles Schwab & Co., Inc. (Schwab) is a securities broker-dealer with 305 domestic branch offices in 45 states, as well as a branch in each of the Commonwealth of Puerto Rico and London, U.K. In addition, Schwab serves clients in Hong Kong through one of CSC s subsidiaries. Other subsidiaries include Charles Schwab Bank, N.A. (Schwab Bank), a retail bank; Charles Schwab Investment Management, Inc., the investment advisor for Schwab s proprietary mutual funds; CyberTrader, Inc., an electronic trading technology and brokerage firm providing services to highly active, online traders; and The Charles Schwab Trust Company, a trustee for employee benefit plans, primarily 401(k) plans.

The accompanying unaudited condensed consolidated financial statements include CSC and its majority-owned subsidiaries (collectively referred to as the Company). These financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and, in the opinion of management, reflect all adjustments necessary to present fairly the financial position, results of operations, and cash flows for the periods presented in conformity with generally accepted accounting principles in the U.S. (GAAP). All adjustments were of a normal recurring nature. Certain prior-year amounts have been reclassified to conform to the 2007 presentation. All material intercompany balances and transactions have been eliminated. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. The Company s results for any interim period are not necessarily indicative of results for a full year or any other interim period.

On November 19, 2006, the Company entered into a definitive agreement with Bank of America Corporation (Bank of America) pursuant to which Bank of America will acquire all of the outstanding common stock of U.S. Trust Corporation (USTC, and with its subsidiaries collectively referred to as U.S. Trust), a subsidiary which provides wealth management services. The transaction is expected to close early in the third quarter of 2007; accordingly, these financial statements reflect U.S. Trust as a discontinued operation for all periods.

2. Significant Accounting Policies

Asset management and administration fees: Asset management and administration fees, which include mutual fund service fees and fees for other asset-based financial services provided to individual and institutional clients, are recognized as revenue over the period that the related service is provided, based upon average net asset balances. The Company earns mutual fund service fees for transfer agent services, shareholder services, administration, and investment management provided to its proprietary funds, and recordkeeping and shareholder services provided to third-party funds. Mutual fund service fees are based upon the daily balances of client assets invested in third-party funds and the Company s proprietary funds. These daily asset balances are based upon quoted market prices. The Company also earns asset management fees for advisory and managed account services, which are based on the daily balances of client assets subject to the specific fee for service.

Interest revenue: Interest revenue represents interest earned on certain assets, which include margin loans to brokerage clients, investments of segregated client cash balances, loans to banking clients, and securities available for sale. Interest revenue is recognized in the period earned

based upon the average daily asset balances and the respective interest rates.

Securities transactions: Trading revenue includes commission revenues and revenues from principal transactions. Clients securities transactions are recorded on the date that they settle, while the related commission revenues and expenses are recorded on the date that the trade occurs. Principal transactions are recorded on the date that the trade occurs.

Cash and cash equivalents: The Company considers all highly liquid investments, including money market funds, interest-bearing deposits with banks, federal funds sold, commercial paper and treasury securities, with original

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THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

maturities of three months or less that are not segregated and on deposit for federal or other regulatory purposes to be cash equivalents.

Cash and investments segregated and on deposit for federal or other regulatory purposes include securities purchased under agreements to resell (resale agreements), which are collateralized by U.S. government securities, and certificates of deposit. Resale agreements are collateralized investing transactions that are recorded at their contractual amounts plus accrued interest. The Company obtains control of collateral (U.S. government securities) with a market value equal to or in excess of the principal amount loaned and accrued interest under resale agreements. Collateral is valued daily by the Company, with additional collateral obtained when necessary. Certificates of deposit are recorded at market value.

Securities owned include securities available for sale which are recorded at fair value based on quoted market prices, where available. Mortgage-backed securities are not exchange traded and are valued based on dealer quotes and a discounted cash flow model with expected cash flow and yield assumption inputs. Long-term certificates of deposit are recorded at market value. Unrealized gains and losses are reported, net of taxes, in accumulated other comprehensive income (loss) included in stockholders equity. Realized gains and losses from sales of securities available for sale are determined on a specific identification basis and are included in other revenue.

Securities owned also includes Schwab Funds® money market funds, fixed income securities, equity and other securities, and equity and bond mutual funds recorded at estimated fair value based on quoted market prices. Unrealized gains and losses are included in trading revenue.

Securities borrowed and securities loaned: Securities borrowed require the Company to deliver cash to the lender in exchange for securities and are included in receivables from brokers, dealers, and clearing organizations. For securities loaned, the Company receives collateral in the form of cash in an amount equal to the market value of securities loaned. Securities loaned are included in payables to brokers, dealers, and clearing organizations. The Company monitors the market value of securities borrowed and loaned, with additional collateral obtained or refunded when necessary. Fees received or paid are recorded in interest revenue or interest expense.

Receivables from brokerage clients include margin loans to clients and are stated net of allowance for doubtful accounts of $2 million at both March 31, 2007 and December 31, 2006. Cash receivables from brokerage clients that remain unsecured or partially secured for more than 30 days are fully reserved. There were no significant losses recognized during the periods presented. At March 31, 2007 and December 31, 2006, the weighted-average interest rate charged on margin loan balances was 8.1% and 8.2%, respectively.

Loans to banking clients are stated net of allowance for loan losses of $5 million and $4 million at March 31, 2007 and December 31, 2006, respectively. The allowance is established through charges to income based on management s evaluation of the existing portfolio. The adequacy of the allowance is reviewed regularly by management, taking into consideration current economic conditions, the existing loan portfolio composition, past loss experience and risks inherent in the portfolio, including the value of impaired loans.

Nonperforming assets included in loans to banking clients consist of financial instruments where the Company has stopped accruing interest (non-accrual financial instruments). Interest accruals are discontinued when principal or interest is contractually past due 90 days or more unless collectibility of the loan is reasonably assured. Non-accrual financial instruments are returned to accrual status only when all delinquent principal and interest payments become current and the collectibility of future principal and interest on a timely basis is reasonably assured.

Loans held for sale consist of fixed-rate and adjustable-rate mortgage loans intended for sale. Loans held for sale are stated at lower of cost or market value. Market value is estimated using quoted market prices for securities backed by similar types of loans.

Equipment, office facilities, and property: Equipment and office facilities are depreciated on a straight-line basis over the estimated useful life of the asset of three to ten years. Buildings are depreciated on a straight-line basis over

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(Unaudited)

twenty years. Leasehold improvements are amortized on a straight-line basis over the lesser of the estimated useful life of the asset or the term of the lease. Software and certain costs incurred for purchasing or developing software for internal use are amortized on a straight-line basis over an estimated useful life of three or five years. Equipment, office facilities, and property are stated at cost net of accumulated depreciation and amortization, except for land, which is stated at cost. Equipment, office facilities, and property are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable.

Drafts Payable represent outstanding checks and electronic transfers that have not yet been presented for payment at a bank.

Derivative financial instruments are recorded on the balance sheet in other assets and other liabilities at fair value based upon dealer quotes and third-party pricing services. As part of its consolidated asset and liability management process, the Company utilizes interest rate swap agreements (Swaps) to effectively convert the interest rate characteristics of a portion of its Medium-Term Notes from fixed to variable. These Swaps have been designated as fair value hedges and therefore, changes in the fair value of the Swaps are offset by changes in the fair value of the hedged Medium-Term Notes.

Schwab Bank s loans held for sale portfolio consists of fixed- and adjustable-rate mortgages, which are subject to a loss in value when market interest rates rise. Schwab Bank uses forward sale commitments to manage this risk. These forward sale commitments have been designated as cash flow hedging instruments with respect to the loans held for sale. Accordingly, the fair values of these forward sale commitments are recorded on the Company s consolidated balance sheet, with gains or losses recorded in other comprehensive income (loss).

Additionally, Schwab Bank uses forward sale commitments to hedge interest rate lock commitments issued on mortgage loans that will be held for sale. Schwab Bank considers the fair value of these commitments to be zero at the commitment date, with subsequent changes in fair value determined solely based on changes in market interest rates. Any changes in fair value of the interest rate lock commitments are completely offset by changes in fair value of the related forward sale commitments.

Income taxes: The Company provides for income taxes on all transactions that have been recognized in the consolidated financial statements in accordance with Statement of Financial Accounting Standards No. 109 Accounting for Income Taxes (SFAS No. 109). Accordingly, deferred tax assets are adjusted to reflect the tax rates at which future taxable amounts will likely be settled or realized. The effects of tax rate changes on future deferred tax assets and deferred tax liabilities, as well as other changes in income tax laws, are recorded in earnings in the period during which such changes are enacted. Beginning January 1, 2007, the Company records uncertain tax positions in accordance with FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes. See note 4, Accounting for Income Taxes, for disclosures pursuant to FIN No. 48.

Stock-based compensation: SFAS No. 123 (revised 2004) Share-Based Payment (SFAS No. 123R) requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment arrangements including employee and director stock option and restricted stock awards.

Stock-based compensation expense is based on awards expected to vest, and therefore has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant based on the Company s historical forfeiture experience and revised in subsequent periods if actual forfeitures differ from those estimates.

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Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

A summary of the Company s stock-based compensation expense and related income tax benefit is as follows:

	Three Months Ended March 31,	
	2007	**2006**
Stock option expense	$ 3	$ 4
Restricted stock expense	9	5
Total stock-based compensation	$ 12	$ 9
Income tax benefit on stock-based compensation	$ 5	$ 4

Long-term incentive compensation: Eligible officers may receive cash long-term incentive plan units under a long-term incentive plan (LTIP). These awards are restricted from transfer or sale and vest annually over a three- to four-year period. Each award provides for a one-time cash payment for an amount that varies based upon the Company s cumulative EPS over the respective performance period of each grant. The Company accrues the estimated total cost for each grant on a straight-line basis over each LTIP s vesting period, with periodic cumulative adjustments to expense as estimates of the total grant cost are revised.

Goodwill: represents the cost of acquired businesses in excess of the fair value of the related net assets acquired. Goodwill is tested for impairment annually and whenever indications of impairment exist. In testing for a potential impairment of goodwill, management estimates the fair value of each of the Company s reporting units (defined as the Company s businesses for which financial information is available and reviewed regularly by management), and compares it to their carrying value. If the estimated fair value of a reporting unit is less than its carrying value, management is required to estimate the fair value of all assets and liabilities of the reporting unit, including goodwill. If the carrying value of the reporting unit s goodwill is greater than the estimated fair value, an impairment charge is recognized for the excess. The Company has elected April 1 as its annual impairment testing date. At March 31, 2007 and December 31, 2006, the Company s goodwill balance was $523 million and $419 million, respectively.

New Accounting Standards

SFAS No. 155 Accounting for Certain Hybrid Financial Instruments was effective for all financial instruments acquired or issued after December 31, 2006. This statement allows financial instruments that contain an embedded derivative to be accounted for as a whole (i.e., eliminating the need to account for the embedded derivative separately) if an election is made to report the whole instrument on a fair value basis. The Company made no such election and therefore, the adoption of SFAS No. 155 did not impact the Company s financial position, results of operations, EPS, or cash flows.

SFAS No. 156 Accounting for Servicing of Financial Assets was effective beginning January 1, 2007. This statement amends the requirements under SFAS No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, for accounting for mortgage servicing assets and servicing liabilities. Previously, servicing assets and servicing liabilities were amortized over the expected period of estimated net servicing income or loss and assessed for impairment or increased obligation at each reporting date. SFAS No. 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, and permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. The adoption of SFAS No. 156 did not impact the Company s financial position, results of operations, EPS, or cash flows.

SFAS No. 157 Fair Value Measurements is effective beginning January 1, 2008. This statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. The adoption of SFAS No. 157 is not expected to have a material impact on the Company s financial position, results of operations, EPS, or cash flows.

SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities was issued in February 2007 and is effective beginning January 1, 2008. This statement permits entities to elect to measure eligible financial instruments,

THE CHARLES SCHWAB CORPORATION

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(Unaudited)

commitments, and certain other arrangements at fair value at specified election dates with changes in fair value recognized in earnings at each subsequent reporting period. The Company is currently evaluating the impact of the adoption of SFAS No. 159 on its financial position, results of operations, EPS, and cash flows.

Emerging Issues Task Force Issue (EITF) No. 06-02 Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43 Accounting for Compensated Absences was effective beginning January 1, 2007. This issue requires the recognition of compensation expense associated with a sabbatical leave or other similar benefit arrangement that does not vest over the requisite service period. The Company previously recorded compensation expense related to its sabbatical program in the period the sabbatical was taken by an employee. As a result of this change in accounting principle, the Company recorded a charge, net of estimated forfeitures, to retained earnings as of January 1, 2007 of $17 million after tax. This accounting change did not have a material impact on the Company s results of operations, EPS, or cash flows.

FIN No. 48 Accounting for Uncertainty in Income Taxes - An Interpretation of SFAS No. 109 was effective beginning January 1, 2007. This interpretation provides new requirements for the recognition, measurement, and disclosure in the financial statements of a tax position taken or expected to be taken in a tax return when there is uncertainty about whether that tax position will ultimately be sustained. The adoption of FIN No. 48 resulted in a charge to retained earnings as of January 1, 2007 of $17 million. The adoption of FIN No. 48 did not have a material impact on the Company s results of operations, EPS, or cash flows.

3. Business Acquisition

On March 31, 2007, the Company completed its acquisition of The 401(k) Company, which offers defined contribution plan services, for $115 million in cash. As of March 31, 2007, the Company s condensed consolidated financial statements include The 401(k) Company as a wholly-owned subsidiary of CSC. Pro-forma financial information for The 401(k) Company is not presented as it is not material to the Company s condensed consolidated financial statements.

The initial recording of goodwill and other intangibles requires subjective judgments concerning estimates of the fair value of acquired assets. Any excess of the purchase price over the fair value of the acquired net assets is recorded as goodwill. As a result of a preliminary purchase price allocation, the Company recorded goodwill of $104 million and intangible assets of $8 million, both of which are deductible for tax purposes over a period of 15 years. The intangible assets, which relate to customer relationships, will be amortized on a straight-line basis over 16 years. The goodwill is attributable to the Schwab Investor Services segment.

The purchase price and resultant recognition of goodwill reflect the Company s increased ability to meet the needs of retirement plans of all sizes, as well as the opportunity to capture rollover accounts from retirement plans served by The 401(k) Company and by cross-selling the Company s other investment and banking services to such accounts.

4. Taxes on Income

With the implementation of FIN No. 48 on January 1, 2007, the Company recorded a charge to retained earnings of $17 million related to various federal and state income tax matters, including estimated interest. The balance of the Company s unrecognized tax benefits at both March 31 and January 1, 2007 is approximately $20 million, which includes $15 million related to discontinued operations. The Company s unrecognized tax benefits, which are included in accrued expenses and other liabilities on the Company s condensed consolidated balance sheets, represent the difference between positions taken on tax return filings compared to the requirements under FIN No. 48 to consider potential tax settlement outcomes. Resolving these uncertain tax matters in the Company s favor would reduce income tax expense from continuing operations by $5 million.

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(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

The Company recognizes interest and penalties related to unrecognized tax benefits in taxes on income. Interest charges for the first quarter of 2007 were not material. At March 31, 2007, the Company had a liability of $4 million for estimated interest on the unrecognized tax benefits.

CSC and its subsidiaries file income tax returns in the federal jurisdiction, as well as most state and local jurisdictions and are subject to routine examinations by the respective taxing authorities. Based upon the expected completion of audits within the next 12 months, management does not expect a change in the unrecognized tax benefits to be material to the financial statements. The federal returns have been audited through 2004 and those audits are complete subject to the resolution of a 1989 tax matter that is pending final decision by the 9th Circuit Court of Appeals. Until final resolution of this matter, all federal and state income tax returns for the years 1989 and after remain technically open for examination.

5. Comprehensive Income

Comprehensive income includes net income and changes in equity except those resulting from investments by, or distributions to, stockholders. Comprehensive income is presented in the following table:

	Three Months Ended March 31,	
	2007	**2006**
Net income	$ 273	$ 243
Other comprehensive income (loss):		
Change in unrealized gain on cash flow hedging instruments:		
Unrealized gain (loss)	(2)	11
Income tax (expense) benefit	1	(5)
Net	(1)	6
Change in unrealized loss on securities available for sale:		
Unrealized gain (loss)	13	(37)
Income tax (expense) benefit	(5)	17

Net	8	(20)
Total other comprehensive income (loss)	7	(14)
Comprehensive income	$ 280	$ 229

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THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Option Price Amounts, Ratios, and as Noted)

(Unaudited)

6. Earnings Per Share

Basic EPS is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed by dividing net income by the weighted-average number of common shares plus the effect of dilutive potential common shares outstanding for the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and unvested restricted stock awards. EPS under the basic and diluted computations are presented in the following table:

	Three Months Ended March 31,	
	2007	**2006**
Net income	$ 273	$ 243
Weighted-average common shares outstanding basic	1,251	1,281
Common stock equivalent shares related to stock incentive plans	15	15
Weighted-average common shares outstanding diluted[1]	1,266	1,296
Basic EPS:		
Income from continuing operations	$ .19	$ .17
Income from discontinued operations, net of tax	$ .03	$ .02
Net income	$ .22	$ .19
Diluted EPS:		
Income from continuing operations	$ .19	$ .17
Income from discontinued operations, net of tax	$ .03	$ .02
Net income	$ .22	$ .19

(1) Antidilutive stock options and restricted stock awards excluded from the calculation of diluted earnings per share were 31 million and 35 million shares for the first quarters of 2007 and 2006, respectively.

7. Regulatory Requirements

CSC is a financial holding company, which is a type of bank holding company subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) under the Bank Holding Company Act of 1956, as amended (the Act). In July 2006, USTC (currently reflected as a discontinued operation for financial statement purposes) became a financial holding company.

Under the Act, the Federal Reserve Board has established consolidated capital requirements for bank holding companies. CSC and USTC are subject to those guidelines. CSC s primary depository institution subsidiaries are Schwab Bank and United States Trust Company, National Association (United States Trust NA).

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(Unaudited)

The regulatory capital and ratios including discontinued operations are as follows:

		Actual		Minimum Capital Requirement		Minimum to be Well Capitalized (1)	
March 31, 2007		**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Tier 1 Capital:	Company	$ 3,893	15.1%	$ 1,031	4.0%	N/A	
	Schwab Bank	$ 754	14.3%	$ 211	4.0%	$ 316	6.0%
	U.S. Trust	$ 844	13.5%	$ 250	4.0%	N/A	
	United States Trust NA	$ 751	12.3%	$ 244	4.0%	$ 366	6.0%
Total Capital:	Company	$ 3,925	15.2%	$ 2,062	8.0%	N/A	
	Schwab Bank	$ 760	14.4%	$ 421	8.0%	$ 527	10.0%
	U.S. Trust	$ 870	13.9%	$ 500	8.0%	N/A	
	United States Trust NA	$ 777	12.7%	$ 488	8.0%	$ 610	10.0%
Leverage:	Company	$ 3,893	8.3%	$ 1,878	4.0%	N/A	
	Schwab Bank	$ 754	6.7%	$ 451	4.0%	$ 564	5.0%
	U.S. Trust	$ 844	8.0%	$ 423	4.0%	N/A	
	United States Trust NA	$ 751	7.3%	$ 414	4.0%	$ 517	5.0%

		Actual		Minimum Capital Requirement		Minimum to be Well Capitalized (1)	
December 31, 2006		**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Tier 1 Capital:	Company	$ 4,137	15.5%	$ 1,066	4.0%	N/A	
	Schwab Bank	$ 705	14.1%	$ 200	4.0%	$ 300	6.0%
	U.S. Trust	$ 875	13.6%	$ 258	4.0%	N/A	
	United States Trust NA	$ 735	11.7%	$ 252	4.0%	$ 377	6.0%
Total Capital:	Company	$ 4,168	15.6%	$ 2,132	8.0%	N/A	
	Schwab Bank	$ 709	14.2%	$ 400	8.0%	$ 500	10.0%
	U.S. Trust	$ 901	14.0%	$ 516	8.0%	N/A	
	United States Trust NA	$ 761	12.1%	$ 503	8.0%	$ 629	10.0%
Leverage:	Company	$ 4,137	8.9%	$ 1,857	4.0%	N/A	
	Schwab Bank	$ 705	6.7%	$ 420	4.0%	$ 525	5.0%
	U.S. Trust	$ 875	7.9%	$ 443	4.0%	N/A	
	United States Trust NA	$ 735	6.8%	$ 434	4.0%	$ 543	5.0%

N/A Not applicable.

(1) Applicable only to depository institutions.

Based on their respective regulatory capital ratios at March 31, 2007 and December 31, 2006, Schwab Bank and United States Trust NA are considered well capitalized (the highest category) pursuant to banking regulatory guidelines.

Schwab is subject to the Uniform Net Capital Rule under the Securities Exchange Act of 1934 (the Rule). Schwab computes net capital under the alternative method permitted by this Rule. This method requires the maintenance of minimum net capital, as defined, of the greater of 2% of aggregate debit balances arising from client transactions or a minimum dollar requirement, which is based on the type of business conducted by the broker-dealer. At March 31, 2007, 2% of aggregate debits was $225 million, which exceeded the minimum dollar requirement for Schwab of $250,000. At March 31, 2007, Schwab s net capital was $1.1 billion (9.5% of aggregate debit balances), which was $837 million in excess of its minimum required net capital and $500 million in excess of 5% of aggregate debit balances. Under the alternative method, a broker-dealer may not repay subordinated borrowings, pay cash dividends, or

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make any unsecured advances or loans to its parent or employees if such payment would result in net capital of less than 5% of aggregate debit balances or less than 120% of its minimum dollar requirement.

8. Commitments and Contingent Liabilities

Guarantees: The Company recognizes, at the inception of a guarantee, a liability for the estimated fair value of the obligation undertaken in issuing the guarantee. The fair values of the obligations relating to standby letters of credit (LOCs) are estimated based on fees charged to enter into similar agreements, considering the creditworthiness of the counterparties. The fair values of the obligations relating to other guarantees are estimated based on transactions for similar guarantees or expected present value measures.

In the normal course of business, the Company provides certain indemnifications (i.e., protection against damage or loss) to counterparties in connection with the disposition of certain of its assets. Such indemnifications are generally standard contractual terms with various expiration dates and typically relate to title to the assets transferred, ownership of intellectual property rights (e.g., patents), accuracy of financial statements, compliance with laws and regulations, failure to pay, satisfy or discharge any liability, or to defend claims, as well as errors, omissions, and misrepresentations. The maximum potential future liability under these indemnifications cannot be estimated. The Company has not recorded a liability for these indemnifications and believes that the occurrence of events that would trigger payments under these agreements is remote.

Separately, the Company has guaranteed certain payments in the event of a termination of certain mutual fund sub-advisor agreements, related to the adoption of AXA Rosenberg LLC s U.S. family of mutual funds, known as the Laudus Funds®. Additionally, the Company has provided indemnifications related to facility leases and technology services to a counterparty in connection with the disposition of certain of its assets. At March 31, 2007, the Company s maximum potential future liability under these agreements was approximately $140 million. Further, as discussed below under Legal contingencies, the Company provided an indemnification to UBS Securities LLC and UBS Americas Inc. (collectively referred to as UBS) for expenses associated with certain litigation. At March 31, 2007, the Company has a recorded liability of approximately $30 million reflecting the estimated fair value of these guarantees and indemnifications. The fair value of these guarantees and indemnifications is not necessarily indicative of amounts that would be paid in the event a payment was required.

The Company has clients that sell (i.e., write) listed option contracts that are cleared by various clearing houses. The clearing houses establish margin requirements on these transactions. The Company satisfies the margin requirements by arranging LOCs, in favor of the clearing houses, which are issued by multiple banks. At March 31, 2007, the aggregate face amount of these outstanding LOCs totaled $1.1 billion. In connection with its securities lending activities, Schwab is required to provide collateral to certain brokerage clients. Schwab satisfies the collateral requirements by arranging LOCs, in favor of these brokerage clients, which are issued by multiple banks. At March 31, 2007, the aggregate face amount of these outstanding LOCs totaled $212 million. No funds were drawn under these LOCs at March 31, 2007.

The Company also provides guarantees to securities clearing houses and exchanges under their standard membership agreement, which requires members to guarantee the performance of other members. Under the agreement, if another member becomes unable to satisfy its obligations to the clearing houses and exchanges, other members would be required to meet shortfalls. The Company s liability under these arrangements is not quantifiable and may exceed the cash and securities it has posted as collateral. However, the potential requirement for the Company to make payments under these arrangements is remote. Accordingly, no liability has been recognized for these transactions.

Legal contingencies: The Company is subject to claims and lawsuits in the ordinary course of business, including arbitrations, class actions, and other litigation, some of which include claims for substantial or unspecified damages. The Company is also the subject of inquiries, investigations, and proceedings by regulatory and other governmental

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agencies. In addition, the Company is responding to certain litigation claims brought against former subsidiaries pursuant to indemnities it has provided to purchasers of those entities.

The Company believes it has strong defenses in all significant matters currently pending and is vigorously contesting liability and the damages claimed. Nevertheless, some of these matters may result in adverse judgments or awards, including penalties, injunctions, or other relief, and the Company may also determine to settle a matter because of the uncertainty and risks of litigation. Predicting the outcome of a matter is inherently difficult, particularly where claimants seek substantial or unspecified damages, or when investigations or legal proceedings are at an early stage. In many cases, including those matters described below, it is not possible to determine whether a loss will be incurred or to estimate the range of that loss until the matter is close to resolution. However, based on current information and consultation with counsel, management believes that the resolution of matters currently pending, including those described below, will not have a material adverse impact on the financial condition or cash flows of the Company, but could be material to the Company s operating results for a particular future period, depending on results for that period.

SoundView Litigation: As part of the sale of Schwab Capital Markets L.P. and all of the outstanding capital stock of SoundView Technology Group, Inc. (SoundView), (collectively referred to as Schwab Soundview Capital Markets, or SSCM), to UBS, the Company agreed to indemnify UBS for certain litigation, including the claims described below.

SoundView and certain of its subsidiaries are among the numerous financial institutions named as defendants in multiple purported securities class actions filed in the United States District Court for the Southern District of New York (the IPO Allocation Litigation) between June and December 2001. The IPO Allocation Litigation was brought on behalf of persons who either directly or in the aftermarket purchased IPO securities between March 1997 and December 2000. The plaintiffs allege that SoundView entities and the other underwriters named as defendants required customers receiving allocations of IPO shares to pay excessive and undisclosed commissions on unrelated trades and to purchase shares in the aftermarket at prices higher than the IPO price, in violation of the federal securities laws. SoundView entities have been named in 31 of the actions, each involving a different company s IPO, and had underwriting commitments in approximately 90 other IPOs that are the subject of lawsuits. SoundView entities have not been named as defendants in these cases, although the lead underwriters in those IPOs have asserted that depending on the outcome of the cases, SoundView entities may have indemnification or contribution obligations based on underwriting commitments in the IPOs. The parties, with the assent of the District Court, selected 17 cases as focus cases for the purpose of case-specific discovery, and in October 2004, the District Court allowed 6 of the focus cases to proceed as class actions. Defendants appealed that decision to the United States Court of Appeals for the Second Circuit, which issued an order on December 5, 2006 reversing the District Court s decision to allow the 6 focus cases to proceed as class actions. On April 6, 2007, the Court of Appeals denied the plaintiffs request for rehearing. The Company will continue to vigorously contest these claims on behalf of SoundView pursuant to the indemnity with UBS.

9. Financial Instruments Subject to Off-Balance Sheet Risk, Credit Risk, or Market Risk

Interest rate swaps: CSC uses Swaps to effectively convert the interest rate characteristics of a portion of its Medium-Term Notes from fixed to variable. These Swaps are structured for CSC to receive a fixed rate of interest and pay a variable rate of interest based on the three-month LIBOR rate. The variable interest rates reset every three months. Information on these Swaps is summarized in the following table:

	March 31, 2007	December 31, 2006
Notional principal amount	$ 253	$ 253
Weighted-average variable interest rate	7.90%	7.91%
Weighted-average fixed interest rate	7.78%	7.78%
Weighted-average maturity (in years)	2.5	2.7

These Swaps have been designated as fair value hedges under SFAS No. 133. Changes in the fair value of the Swaps

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are offset by changes in fair value of the hedged Medium-Term Notes. At March 31, 2007 and December 31, 2006, CSC recorded a derivative asset of $1 million and approximately $500,000, respectively, for these Swaps.

Forward sale and interest rate lock commitments: Schwab Bank s loans held for sale portfolio consists of fixed- and adjustable-rate mortgages, which are subject to a loss in value when market interest rates rise. Schwab Bank uses forward sale commitments to manage this risk. These forward sale commitments have been designated as cash flow hedging instruments with respect to the loans held for sale. Accordingly, the fair values of these forward sale commitments are recorded on the Company s condensed consolidated balance sheets, with gains or losses recorded in other comprehensive income (loss). Amounts included in other comprehensive income (loss) are reclassified into earnings when the related loan is sold. At both March 31, 2007 and December 31, 2006, the derivative asset and liability recorded by Schwab Bank for these forward sale commitments was immaterial.

Additionally, Schwab Bank uses forward sale commitments to hedge interest rate lock commitments issued on mortgage loans that will be held for sale. Schwab Bank considers the fair value of these commitments to be zero at the commitment date, with subsequent changes in fair value determined solely based on changes in market interest rates. Any changes in fair value of the interest rate lock commitments are completely offset by changes in fair value of the related forward sale commitments. Schwab Bank had interest rate lock commitments on mortgage loans to be held for sale with principal balances totaling approximately $153 million and $122 million at March 31, 2007 and December 31, 2006, respectively. At both March 31, 2007 and December 31, 2006, the derivative asset and liability recorded by Schwab Bank for these interest rate lock commitments and the related forward sale commitments was immaterial.

10. Segment Information

The Company structures its segments according to its various types of clients and the services provided to those clients. The Company s two reportable segments are Schwab Investor Services and Schwab Institutional®. As a result of the Company s pending sale of U.S. Trust in 2007, the previously-reported U.S. Trust segment has been eliminated. The Company evaluates the performance of its segments on a pre-tax basis excluding items such as restructuring charges, impairment charges, discontinued operations, and extraordinary items. Intersegment net revenues are not material and are therefore not disclosed.

Financial information for the Company s reportable segments is presented in the following table:

	Three Months Ended March 31,

	2007	2006
Net revenues:		
Schwab Investor Services	$ 868	$ 802
Schwab Institutional	261	238
Unallocated and other [1]	24	14
Total net revenues	$ 1,153	$ 1,054
Income from continuing operations before taxes on income:		
Schwab Investor Services	$ 277	$ 246
Schwab Institutional	109	109
Unallocated and other	5	(2)
Income from continuing operations before taxes on income	391	353
Taxes on income	(155)	(139)
Income from discontinued operations, net of tax	37	29
Net income	$ 273	$ 243

[1] Includes mutual fund clearing services revenues, and gains (losses) on investments.

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11. Supplemental Cash Flow Information

Certain information affecting the cash flows of the Company is presented in the following table:

	Three Months Ended March 31,	
	2007	**2006**
Income taxes paid [1]	$ 12	$ 37
Interest paid:		
Brokerage client cash balances	$ 97	$ 110
Deposits from banking clients	60	26
Long-term debt	5	6
Other	6	5
Total interest paid	$ 168	$ 147

(1) Includes discontinued operations.

12. Discontinued Operations

On November 19, 2006, CSC entered into a definitive agreement with Bank of America pursuant to which Bank of America will acquire all of the outstanding common stock of U.S. Trust for $3.3 billion in cash. The transaction is expected to close early in the third quarter of 2007. However, the closing is subject to (i) approval of new investment advisor agreements for each of the Excelsior® mutual funds by the applicable public fund board and the stockholders of each fund and (ii) other customary closing conditions. The Company estimates it will record a pre-tax gain on the sale of approximately $1.9 billion. After-tax proceeds will be used for general corporate purposes, including share repurchases and continued investment in Schwab Investor Services, Schwab Institutional, and Schwab Bank. U.S. Trust comprised all of the previously-reported U.S. Trust segment.

The results of operations, net of income taxes, and cash flows of U.S. Trust have been presented as discontinued operations on the Company s condensed consolidated statements of income and of cash flows for all periods, and the assets and liabilities of U.S. Trust have each been

combined and presented as assets and liabilities of discontinued operations on the Company s condensed consolidated balance sheets. The Company s consolidated prior period revenues, expenses, taxes on income, assets, liabilities, and cash flows also reflect this presentation.

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Summarized financial information for discontinued operations related to U.S. Trust is as follows:

	March 31, 2007	December 31, 2006
Assets		
Cash and cash equivalents	$ 76	$ 625
Cash and investment segregated and on deposit for federal and other regulatory purposes	12	11
Loans to banking clients net	7,064	7,090
Securities owned	2,472	2,571
Equipment, office facilities, and property net	99	97
Goodwill	390	390
Intangible assets net	119	119
Other assets	432	442
Assets retained from discontinued operations	(747)	(749)
Total assets	$ 9,917	$ 10,596
Liabilities		
Deposits from banking clients (net of liabilities retained)	$ 7,652	$ 8,532
Accrued expenses and other liabilities	295	379
Short-term borrowings	408	101
Long-term debt		52
Total liabilities	$ 8,355	$ 9,064

The components of income from discontinued operations related to U.S. Trust are as follows:

	Three Months Ended March 31,	
	2007	2006
Net revenues	$ 219	$ 225
Income, before taxes	$ 58	$ 46

Taxes on income	$	(22)	$	(18)
Income, net of tax	$	36	$	28

In the fourth quarter of 2006, the Company recorded a $205 million income tax benefit related to the estimated difference between the tax and book bases of the Company s U.S. Trust stock. This amount is included in income from discontinued operations, net of tax on the Company s consolidated statements of income. When calculating the Company s gain on the sale of U.S. Trust for income tax purposes, the tax basis will be the basis of U.S. Trust s prior stockholders in their shares as of the date U.S. Trust was acquired by the Company, since the transaction qualified as a tax-free exchange. This tax benefit is management s current estimate and is based on publicly available information, including information on the composition of U.S. Trust s stockholders at the acquisition date and the market price of U.S. Trust stock during relevant periods. The final amount of the basis difference, which could differ from management s estimate, will be determined following a survey of former U.S. Trust stockholders that the Company expects to complete in mid-2007.

The assets retained from discontinued operations reflect the excess cash held in certain Schwab brokerage client accounts that is swept into a money market deposit account at U.S. Trust. In 2007, Schwab will terminate this arrangement prior to the closing of the sale of U.S. Trust and move these balances to a similar existing arrangement with Schwab Bank. At March 31, 2007 and December 31, 2006, these balances totaled $747 million and $749 million, respectively, and are included in deposits from banking clients with a corresponding amount in assets

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retained from discontinued operations on the Company s condensed consolidated balance sheets. The interest expense related to these client deposit balances is included in interest expense from continuing operations on the Company s condensed consolidated statements of income of $3 million and $2 million for the first quarters of 2007 and 2006, respectively. The corresponding interest revenue on the invested cash balances related to these deposits is included in interest revenue from continuing operations on the Company s condensed consolidated statements of income of $10 million and $8 million for the first quarters of 2007 and 2006, respectively. The interest revenue amount is calculated using the Company s funds transfer pricing methodology, which is used by management to estimate the interest earned on the investment of these deposit balances.

13. Restructuring Reserve

A summary of the activity in the facilities restructuring reserve related to the Company s past restructuring initiatives, as well as certain retained restructuring-related obligations following the past sales of SSCM and Charles Schwab Europe, for the first quarter of 2007 is as follows:

Balance at December 31, 2006	$ 112
Restructuring credit [1]	(2)
Cash payments - net	(10)
Other [2]	1
Balance at March 31, 2007 [3]	$ 101

(1) Represents change in sublease assumptions.

(2) Primarily includes the accretion of facilities restructuring reserves, which are initially recorded at net present value. Accretion expense is recorded in occupancy and equipment expense on the Company s condensed consolidated statements of income.

(3) The Company expects to substantially utilize the remaining facilities restructuring reserve through cash payments for the net lease expense over the respective lease terms through 2017.

The actual costs of the remaining restructuring reserve related to these restructuring initiatives could differ from the estimated costs, depending primarily on the Company s ability to sublease properties.

THE CHARLES SCHWAB CORPORATION

Management s Discussion and Analysis of Financial Condition and Results of Operations

(Tabular Amounts in Millions, Except Ratios, and as Noted)

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

OVERVIEW

Management of The Charles Schwab Corporation (CSC) and its subsidiaries (collectively referred to as the Company) focuses on several key financial and non-financial metrics in evaluating the Company s financial position and operating performance. All information contained in this Form 10-Q is presented on a continuing operations basis unless otherwise noted. Results for the first quarters of 2007 and 2006 are shown in the following table:

	Three Months Ended March 31,		
	2007	**2006**	**Percent Change**
Client Activity Metrics:			
Net new client assets (in billions) [1]	$ 51.3	$ 26.4	94%
Client assets (in billions, at quarter end)	$ 1,305.7	$ 1,128.9	16%
Clients daily average trades (in thousands)	230.4	275.2	(16%)
Company Financial Metrics:			
Net revenue growth from prior year s period	9%	24%	
Pre-tax profit margin from continuing operations	33.9%	33.5%	
Return on stockholders equity	22%	21%	
Annualized net revenue per average full-time equivalent employee (in thousands) [2]	$ 366	$ 363	1%

(1) Includes inflows of $17.8 billion in the first quarter of 2007 related to the acquisition of The 401(k) Company.

(2) Amount excludes 365 employees related to the acquisition of The 401(k) Company on March 31, 2007 as there was no related revenue recorded in the first quarter of 2007.

During the first quarter of 2007, the Company continued to strengthen its operating and financial performance despite heightened economic uncertainty and securities market volatility. Net new client assets of $51.3 billion for the first quarter of 2007 included $17.8 billion associated with the acquisition of The 401(k) Company, which closed on March 31, 2007. The remaining $33.5 billion of net new client assets was 27% higher than the first quarter of 2006. Total client assets rose by 16% from the first quarter of 2006 to a record $1.306 trillion at March 31, 2007. Net revenues grew on a year-over-year basis, rising by 9% compared to the first quarter of 2006. This increase was primarily due to higher interest rate spreads resulting from the higher interest rate environment, as well as growth in client assets. These factors contributed to a 15% increase in asset-based and other revenues (which include asset management and administration fees, net interest revenue, and other revenues) to

a record $951 million. Total expenses in the first quarter of 2007 increased $61 million, or 9%, compared to the first quarter of 2006, primarily due to higher compensation and benefits expense, advertising and market development expense, and professional services expense. Pre-tax profit margin from continuing operations was 33.9%, which represents an increase from 33.5% in the first quarter of 2006. Net income grew to $273 million, up 12% compared to the first quarter of 2006. Return on stockholders equity increased to 22% in the first quarter of 2007, compared to 21% in the first quarter of 2006, as earnings grew and the Company continued to actively manage its capital base.

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Management s Discussion and Analysis of Financial Condition and Results of Operations

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Discontinued Operations

On November 19, 2006, CSC entered into a definitive agreement with Bank of America Corporation (Bank of America) pursuant to which Bank of America will acquire all of the outstanding common stock of U.S. Trust Corporation (USTC, and with its subsidiaries collectively referred to as U.S. Trust) for $3.3 billion in cash. The transaction is expected to close early in the third quarter of 2007. However, the closing is subject to (i) approval of new investment advisor agreements for each of the Excelsior® mutual funds by the applicable public fund board and the stockholders of each fund and (ii) other customary closing conditions. The Company estimates it will record a pre-tax gain on the sale of approximately $1.9 billion. After-tax proceeds will be used for general corporate purposes, including share repurchases and continued investment in Schwab Investor Services, Schwab Institutional, and Schwab Bank. U.S. Trust comprised all of the previously-reported U.S. Trust segment.

The results of operations, net of income taxes, and cash flows of U.S. Trust have been presented as discontinued operations on the Company s condensed consolidated statements of income and of cash flows, respectively, and the assets and liabilities of U.S. Trust have been combined and presented as assets and liabilities of discontinued operations on the Company s condensed consolidated balance sheets. The Company s consolidated prior period revenues, expenses, taxes on income, assets, liabilities, and cash flows also reflect this presentation.

Business Acquisition

On March 31, 2007, the Company completed its acquisition of The 401(k) Company, which offers defined contribution plan services, for $115 million in cash. As a result of a preliminary purchase price allocation, the Company recorded goodwill of $104 million and intangible assets of $8 million. The intangible assets will be amortized over 16 years.

Subsequent Event

On April 9, 2007, Peter K. Scaturro stepped down as Chief Executive Officer of U.S. Trust and from his position on the Management Committee of CSC. Mr. Scaturro is expected to remain with the Company through the closing of the sale of U.S. Trust to Bank of America.

RESULTS OF OPERATIONS

	Three Months	Percent Change

	Ended March 31,		
	2007	2006	
Asset-based and other revenues	$ 951	$ 827	15%
Trading revenue	202	227	(11%)
Total net revenues	1,153	1,054	9%
Expenses excluding interest	762	701	9%
Income from continuing operations before taxes on income	391	353	11%
Taxes on income	(155)	(139)	12%
Income from continuing operations	236	214	10%
Income from discontinued operations, net of tax	37	29	28%
Net income	$ 273	$ 243	12%
Earnings per share diluted	$ .22	$ .19	
Pre-tax profit margin from continuing operations	33.9%	33.5%	
Effective income tax rate on income from continuing operations	39.6%	39.4%	

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The increase in asset-based and other revenues was due to an increase in asset management and administration fees resulting from higher levels of client assets, and an increase in net interest revenue resulting from yields on assets increasing faster than those on liabilities. The decline in trading revenue was primarily due to lower daily average revenue trades, partially offset by higher average revenue earned per revenue trade.

The increase in expenses excluding interest was mainly due to higher compensation and benefits expense, advertising and market development expense, and professional services expense.

Segment Information

The Company provides financial services to individuals and institutional clients through two segments Schwab Investor Services and Schwab Institutional®. The Schwab Investor Services segment includes the Company s retail brokerage and banking operations, as well as the Schwab Retirement Plan Services division. The Schwab Institutional segment provides custodial, trading, and support services to independent investment advisors.

Financial information for the Company s reportable segments is presented in the following table:

	Three Months Ended March 31,		Percent
	2007	**2006**	**Change**
Schwab Investor Services:			
Net revenues	$ 868	$ 802	8%
Expenses excluding interest	$ 591	$ 556	6%
Contribution margin	$ 277	$ 246	13%
Schwab Institutional:			
Net revenues	$ 261	$ 238	10%
Expenses excluding interest	$ 152	$ 129	18%
Contribution margin	$ 109	$ 109	

Unallocated and other:

Our Manager acquired 2,000,000 shares of trust stock from the company concurrently with the closing of the initial public offering with an aggregate purchase price of $50 million, at a purchase price per share equal to the initial public offering price of $25. Pursuant to the terms of the management services agreement (discussed below), our Manager may sell up to 65% of these shares at any time and may sell the balance at any time from and after December 21, 2007. On April 19, 2005, we issued 433,001 shares of trust stock to our Manager as consideration for

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the $12.1 million performance fee due for the fiscal quarter ended December 31, 2004. On June 27, 2006, we issued 145,547 shares of trust stock to our Manager upon reinvestment of the $4.1 million performance fee due to our Manager for the fiscal quarter ended March 31, 2006.

We entered into a registration rights agreement with our Manager under which we agreed to file a shelf registration statement under the Securities Act relating to the resale of all the shares owned by our Manager as soon as reasonably possible following December 21, 2005 to cover 30% of our Manager s initial investment as well as any additional shares purchased by our Manager upon the reinvestment of any of its management fees. In addition, our Manager may also require us to include its shares in future registration statements that we file, subject to cutback at the option of the underwriters of any such offering. On October 16, 2006, we filed a shelf registration statement on Form S-3 with the SEC, which became automatically effective. The shelf registration statement covers resales by our Manager of any shares of trust stock registrable under the registration rights agreement.

Management Services Agreement

At the closing of our initial public offering, we entered into a management services agreement with our Manager, providing for its management of our day-to-day operations and affairs and oversight of the management teams of our operating businesses.

Secondment of our Chief Executive Officer and Chief Financial Officer. Neither the trust nor the company have any employees. Our Manager has assigned, or seconded, to the company, on a permanent and wholly dedicated basis, two of its employees to assume the offices of chief executive officer and chief financial officer and seconds or makes other personnel available as required. The services performed for the company are provided at our Manager s cost, including the compensation of seconded personnel.

Management Fees. We have agreed to pay our Manager a base management fee based primarily on our market capitalization. In addition, to incentivize our Manager to maximize shareholder returns, we have agreed to pay performance fees to our Manager equal to 20% of the outperformance, if any, of quarterly total returns to shareholders compared to a weighted average of two benchmark indices, a U.S. utilities index and a European utilities index, weighted in proportion to our U.S. and non-U.S. equity investments. As a result of the sales during

2006 of our non-U.S. businesses and investments, 100% of the weighting is allocated to U.S. investments. To be eligible for the performance fee, our Manager must deliver total shareholder returns for the quarter that are positive and in excess of any prior underperformance. For the year ended December 31, 2006, base management fees of $14.5 million and performance fees of $4.1 million were payable to our Manager. Our Manager has elected to apply the performance fee to a subscription for shares of trust stock which were issued in June 2006 at a per share price based on a volume weighted average trading price of the trust stock in accordance with the terms of the management services agreement. For the year ended December 31, 2005, base management fees of $9.3 million were payable to our Manager, of which $2.5 million was paid in 2006. For the quarter ended March 31, 2007, our Manager earned a performance fee of $957,000, which it has elected to reinvest in shares of trust stock, which we expect to issue in June. Base management fees for the first quarter of 2007 have not yet been determined.

Our Manager is not entitled to any other compensation and all costs incurred by our Manager including compensation of seconded staff, are paid out of its management fee. However, the company is responsible for other direct costs including, but not limited to, expenses incurred in the administration or management of the company and its subsidiaries and investments, income taxes, audit and legal fees, and acquisitions and dispositions and its compliance with applicable laws and regulations. During the year ended December 31, 2006, our Manager received a tax refund of $377,000 on our behalf and paid out-of-pocket expenses of $360,000 on our behalf. During the quarter ended March 31, 2007, our Manager charged us $57,000 for reimbursement of out-of-pocket expenses.

Appointees to the Board. Under the terms of the management services agreement and the LLC agreement, for so long as our Manager or any of its affiliates holds a total of 200,000 shares of trust stock (as adjusted to reflect any stock splits or similar recapitalizations), our Manager has the right to appoint one director to the board of directors and an alternate for such appointee and such director, or alternate if applicable, will serve as the chairman of our board. Our Manager s appointees will not receive any compensation (other than out-of-pocket expenses) and will not have any special voting rights. The appointees of our Manager do not participate in decisions regarding, or vote on, any related party transactions, including those in which any affiliate of our Manager has an interest.

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Acquisition Opportunities. Under the terms of the management services agreement, our Manager has exclusive responsibility for reviewing and making recommendations to the board with respect to acquisition opportunities and dispositions. In the event that an opportunity is not originated by our Manager, our board must seek a recommendation from our Manager prior to making a decision concerning any acquisition or disposition. Our Manager and its affiliates refer to the company s board of directors any acquisition opportunities in accordance with the U.S. acquisition priorities below that are made available to the IB Funds division of the Macquarie Group unless our chief executive officer determines that such opportunity does not meet our acquisition criteria adopted by the company s board of directors.

We have first priority ahead of all current and future entities managed by our Manager or by members of the Macquarie Group within the IB Funds division in each of the following infrastructure acquisition opportunities that are within the United States:

Sector	
Airport fixed base operations	
District energy	
Airport parking	
User pays assets, contracted assets and regulated assets (as defined below) that represent an investment of greater than AUD 40 million ($32.4 million as of March 31, 2007), subject to the following qualifications:	
Roads	The Company has second priority after Macquarie Infrastructure Group, any successor thereto or spin-off managed entity thereof or any one managed entity to which Macquarie Infrastructure Group has transferred a substantial interest in its U.S. Assets; provided that, in the case of such transferee, both Macquarie Infrastructure Group and such entity are co-investing in the proposed

	investment.
Airport ownership	The Company has second priority after Macquarie Airports (consisting of Macquarie Airports Group and Macquarie Airports), any successor thereto or spin-off managed entity thereof or any one managed entity to which Macquarie Airports has transferred a substantial interest in its U.S. Assets; provided that, in the case of such transferee, both Macquarie Airports and such entity are co-investing in the proposed investment.
Communications	The Company has second priority after Macquarie Communications Infrastructure Group, any successor thereto or spin-off managed entity thereof or any one managed entity to which Macquarie Communications Infrastructure Group has transferred a substantial interest in its U.S. Assets; provided that, in the case of such transferee, both Macquarie Communications Infrastructure Group and such entity are co-investing in the proposed investment.
Regulated assets (including, but not limited to, electricity and gas transmission and distribution and water services)	The company has second priority after Macquarie Essential Assets Partnership, or MEAP, until such time as MEAP has invested a further CAD 45 million ($51.8 million as of March 31, 2007) in the United States. Thereafter, the company will have first priority.

User pays assets mean businesses that are transportation related and derive a majority of their revenues from a per use fee or charge.

Contracted assets mean businesses that derive a majority of their revenues from long-term contracts with other businesses or governments.

Regulated assets mean businesses that are the sole or predominant providers of at least one essential service in their service areas and where the level of revenue earned or charges imposed are regulated by government entities.

The company has first priority ahead of all current and future entities managed by our Manager or any Manager affiliate in all investment opportunities originated by a party other than our Manager or any Manager affiliate where such party offers the opportunity exclusively to the company and not to any other entity managed by our Manager or any Manager affiliate within the IB Funds division of the Macquarie Group.

Preferred Financial Advisor. Affiliates of the Macquarie Group, including Macquarie Securities (USA) Inc., or Macquarie Securities, have preferred provider status in respect of any financial advisory services to be contracted for by us. We will contract for such services on an arm s-length basis on market terms upon approval by our audit committee. Any fees payable for such financial advisory services are in addition to fees paid under the management services agreement. Macquarie Securities has been engaged as our financial advisor in connection with a number of pending transactions for which no fees have been paid to date.

Advisory Services from the Macquarie Group

During the year ended December 31, 2006, the Macquarie Group has provided various advisory services to us, and has incurred expenses reimbursable by us, in connection with our acquisitions, dispositions and debt funding, comprising the following (in thousands):

		(In thousands)
Acquisition of IMTT acquisition advisory services from Macquarie Securities	$	4,232
Acquisition of The Gas Company	$	3,750

acquisition advisory services from Macquarie Securities		
debt advisory services from Macquarie Securities	$	900
Acquisition of Trajen		
acquisition advisory services from Macquarie Securities	$	5,260
debt advisory services from Macquarie Securities	$	900
Sale of equity in Macquarie Communications Infrastructure Group broker services from Macquarie Securities (Australia) Limited	$	231
Disposition of interest in South East Water financial advisory services from MBL (1)	$	933
Disposition of our toll road business financial advisory services from MBL	$	867
Airport parking business refinancing debt advisory services from Macquarie Securities	$	1,463
MIC Inc. acquisition credit facility increase debt advisory services from Macquarie Securities	$	575

(1) We sold our interest in South East Water to a third party on the same terms as, and pursuant to the exercise of drag along rights under the shareholders agreement by, MEIF Luxembourg Holdings SA, or MEIF, an affiliate of our Manager, and as a part of a sale by MEIF and the other shareholders of all of their respective interests in South East Water.

During the year ended December 31, 2006, the Macquarie Group charged us an aggregate of $106,000 for reimbursement of out-of-pocket expenses, in relation to work performed on various advisory roles for us.

We expect to pay acquisition and debt advisory fees to Macquarie Securities relating to our previously announced acquisition of Mercury Air Centers, Inc. of approximately $5.5 million and $3.0 million, respectively,

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assuming a subsequent debt refinancing with substantially the same financial terms as Atlantic s current debt facility and subject to increases for improved financial terms. We also expect to pay acquisition and debt advisory fees to Macquarie Securities relating to a previously announced pending acquisition of two fixed base operations in our airport services business of approximately $1.3 million and $163,000, respectively, when the acquisition closes. We have and will continue to enter into other financial advisory arrangements with Macquarie Securities or other members of the Macquarie group from time to time in connection with contemplated and future debt and equity transactions.

Debt Facilities and Derivative Instruments

MIC Inc. Acquisition Credit Facility

On May 9, 2006, we amended our acquisition credit facility, originally entered into on November 11, 2005, pursuant to which the commitments under the acquisition credit facility were increased to provide for a $300 million revolving credit facility and a term loan of $180 million through March 31, 2008. The term loan portion of the acquisition credit facility was used to partially fund the acquisition of Trajen, and the revolving credit facility portion was used to partially fund the acquisitions of IMTT and The Gas Company. We repaid our acquisition facility in full with the proceeds from the sale of our interests in South East Water and Macquarie Communications Infrastructure Group and our 2006 equity offering discussed below under Equity Offering. The term loan portion may not be reborrowed. MBL is a lender under the acquisition credit facility with an aggregate commitment thereunder of $100.0 million. In April 2007, MBL assigned to a third party all of its rights and obligations under the agreement related to $50.0 million of its aggregate commitment. Amounts relating MBL s portion of this loan for the year ended December 31, 2006 comprise the following (in thousands):

Portion of loan outstanding from MBL, as at December 31, 2006		
Largest aggregate principal amount outstanding from MBL during 2006	$	100,000
Principal paid to MBL during 2006	$	100,000
Interest expense on MBL portion of loan	$	3,540
Fees paid to MBL for the increase in facility	$	250

Airport Services Business

On June 28, 2006, our airport services business entered into an agreement to expand its existing $300 million term loan to $480 million, of which MBL provided $40 million in additional term loan borrowing. Amounts relating to the portion of the loan from MBL comprise the following (in thousands):

Portion of loan outstanding from MBL, as at December 31, 2006	$	50,000
Largest aggregate principal amount outstanding from MBL during 2006	$	60,000
Principal paid to MBL during 2006	$	
Interest expense on MBL portion of loan	$	3,164
Financing fee to MBL	$	307

In 2006, Macquarie Bank Limited assigned $25 million of its loan balance to an unaffiliated third party and, subsequently, increased its loan balance by $15 million in connection with our acquisition of Trajen, resulting in an aggregate loan balance of $50 million at the end of 2006. In February 2007, we entered into an amendment to expand the size of the facility by $32.5 million, committed by unaffiliated lenders, which will be used to fund the acquisition of two additional FBOs.

Derivative Instruments

Our airport services business has swaps in place hedging 100% of the $512.5 million principal amount of its debt facility. MBL is providing interest rate swaps with a notional amount of $313.3 million ($280.8 million as of December 31, 2007) for the airport services business long-term debt. MBL made payments to the airport services business of $802,000 for the year ended December 31, 2006 and $189,000 for the first quarter of 2007. In January 2007, the airport services business paid MBL $40,000.

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Our gas production and distribution business has swaps in place hedging $160 million of the principal amount of its debt facilities. MBL is providing interest rate swaps with a notional amount of $48.0 million for this debt and made payments to the gas production and distribution business of $83,000 for the year ended December 31, 2006 and $63,000 for the first quarter of 2007.

We entered into foreign-exchange related derivative instruments with Macquarie Bank Limited to manage our exchange rate exposure on our cash flows from our non-U.S. investments, including cash flows from the dispositions of non-U.S. investments. During the year ended December 31, 2006, we paid £2.4 million and $124.1 million to MBL and received $4.4 million and £65.6 million which closed out four foreign currency forward contracts relating to our interest in South East Water. During 2006, we also paid £26.1 million to MBL and received $49.2 million which closed out three foreign currency forward contracts relating to our toll road business in the UK. During the same period, we paid AUD $50.5 million to MBL and received $38.4 million which closed out two foreign currency forward contracts between the parties related to our interest in Macquarie Communications Infrastructure Group. As of December 31, 2006, each of these contracts had terminated.

Equity Offering

In the fourth quarter of 2006, we completed an underwritten public offering of 10,350,000 shares of trust stock pursuant to our existing shelf registration statement. Macquarie Securities acted as an underwriter in the equity offering, and received underwriting discounts of approximately $482,000 in connection with its acting as underwriter.

Other Related Party Transactions

The Company was reimbursed by MSUSA for 50% of all due diligence costs incurred in relation to an acquisition that was not completed. The amount reimbursed for the year ended December 31, 2006 was $461,000. In addition, the Company reimbursed an affiliate of MBL $1,600 for out-of-pocket expenses incurred in relation to the same acquisition.

The Company paid 6,600 ($8,700 as of December 31, 2006) to affiliates of MBL for professional services and rent expense for premises in Luxembourg in connection with our Luxembourg domiciled subsidiary.

The Company and its airport services and airport parking businesses pay fees for employee consulting services to the Detroit and Canada Tunnel Corporation, which is owned by an entity managed by the Macquarie Group. Fees paid for 2006 were $19,000.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our directors and officers, and persons who beneficially own more than ten percent of our common stock, to file initial reports of ownership and reports of changes in ownership of our common stock and our other equity securities with the Securities and Exchange Commission. As a practical matter, we assist our directors and officers by monitoring transactions and completing and filing Section 16 reports on their behalf. In 2006, the following transactions, were not timely reported:

Grants of restricted stock units in May 2006 to Messrs. Brown, Webb and Carmany,

An open market purchase of shares of trust stock by Mr. Roberts in June 2006,

Grants of interests in the Macquarie DPS Plan to Mr. Stokes in July 2006 that were notionally invested in shares of trust stock and

An open market purchase of shares of trust stock by Macquarie Bank Limited in August 2006 to hedge certain potential payment obligations under its DPS Plan.

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SHAREHOLDER PROPOSALS FOR THE 2008 ANNUAL MEETING OF SHAREHOLDERS

To be considered for inclusion in our proxy statement for the 2008 Annual Meeting of Shareholders, shareholder proposals must be received by the company no later than January 23, 2008 and no earlier than December 24, 2007. In order to be included in company-sponsored proxy materials, shareholder proposals will need to comply with Rule 14a-8 promulgated under the Exchange Act. If you do not comply with Rule 14a-8, we will not be required to include the proposal in the proxy statement and the proxy card we will mail to shareholders. No other business (other than matters included in our proxy statement in accordance with Rule 14a-8) may be presented for action at the annual meeting unless a shareholder gives timely notice of the proposal in writing to the Secretary. To be timely, a shareholder s notice is required to be delivered to the Secretary not less than 120 days nor more than 150 days prior to the first anniversary of the preceding year s annual meeting. Shareholder proposals should be sent to Macquarie Infrastructure Company LLC, 125 West 55th Street, New York, New York 10019, United States of America, Attention: General Counsel and Secretary.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION REPORTS

Copies of our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as filed with the SEC, are available to shareholders free of charge on our website at *www.macquarie.com/mic* under the caption Investor Center SEC Filings or by writing to us at 125 West 55th Street, New York, New York 10019, United States of America, Attention: Investor Relations.

OTHER MATTERS

We know of no other business that will be brought before the Annual Meeting. If any other matter or any proposal should be properly presented and should properly come before the meeting for action, the persons named in the accompanying proxy will vote upon such proposal at their discretion and in accordance with their best judgment.

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MACQUARIE INFRASTRUCTURE COMPANY
THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS
FOR THE 2007 ANNUAL MEETING OF SHAREHOLDERS TO BE HELD ON MAY 24, 2007.

The undersigned hereby appoints Peter Stokes and Frank Joyce, and each of them, attorneys and proxies with full power of substitution, to represent and to vote on behalf of the undersigned all of the shares of trust stock of Macquarie Infrastructure Company Trust that the undersigned is entitled in any capacity to vote if personally present at the 2007 Annual Meeting of Shareholders to be held on May 24, 2007, and at any adjournments or postponements thereof, in accordance with the instructions set forth on the reverse and with the same effect as though the undersigned were present in person and voting such shares. The proxies are authorized in their discretion to vote for the election of a person to the board of directors if any nominee named herein becomes unable to serve or for good cause will not serve, upon all matters incident to the conduct of the meeting, and upon such other business as may properly come before the meeting.

PLEASE RETURN THIS PROXY CARD AFTER SIGNING AND DATING IT.

THIS PROXY WILL BE VOTED AS DIRECTED. IF THIS PROXY IS SIGNED, BUT NO DIRECTION IS MADE, IT WILL BE VOTED IN ACCORDANCE WITH THE RECOMMENDATION OF THE BOARD OF DIRECTORS OF MACQUARIE INFRASTRUCTURE COMPANY LLC.

MACQUARIE INFRASTRUCTURE COMPANY
P.O. Box 11209
New York, N.Y. 10203-0209

(Continued and to be dated and signed on reverse side.)

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DETACH PROXY CARD HERE

Mark, Sign, Date and Return the Proxy Card Promptly Using the Enclosed Envelope.	ý **Votes must be indicated (X) in Black or Blue Ink**

Macquarie Infrastructure Company LLC s Board of Directors Recommends a Vote **FOR** Proposals 1 and 2, below.

1. To elect as directors all nominees listed (except as marked to the contrary below):

FOR	WITHHOLD	FOR ALL EXCEPT
o	o	o

2. To ratify the appointment of KPMG LLP as independent auditor:

FOR	AGAINST	ABSTAIN
o	o	o

Nominees: 01 Norman H. Brown, Jr., 02 George W. Carmany, III, 03 William H. Webb

INSTRUCTION: **To withhold authority to vote for any individual nominee, mark For All Except box and strike a line through the nominee s name. Your shares will be voted for the remaining nominee(s).**

To change your address, please mark this box. o

To include any comments, please mark this box. o

SCAN LINE

Sign exactly as imprinted (do not print). If shares are

held jointly, EACH holder should sign. Executors, administrators, trustees, guardians and others signing in a representative capacity should indicate the capacity in which they sign. An authorized officer signing on behalf of a corporation should indicate the name of the corporation and the officer s title.

Date	Signature	Co-Owner (if any) Signature