

FRANKLIN RESOURCES INC  
Form 10-Q  
February 09, 2007

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended December 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: 001-09318

**FRANKLIN RESOURCES, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation

**13-2670991**  
(I.R.S. Employer Identification No.)

or organization)

**One Franklin Parkway, San Mateo, CA**  
(Address of principal executive offices)

**94403**  
(Zip Code)

**(650) 312-3000**

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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

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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. (Check one):

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

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

Outstanding: 253,656,949 shares of common stock, par value \$0.10 per share, of Franklin Resources, Inc. as of January 31, 2007.

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## PART I FINANCIAL INFORMATION

### Item 1. Financial Statements. FRANKLIN RESOURCES, INC.

#### Condensed Consolidated Statements of Income

##### Unaudited

|  | Three Months Ended |                   |
|--|--------------------|-------------------|
|  | December 31,       |                   |
|  | 2006               | 2005              |
| <i>(in thousands, except per share data)</i>           |                    |                   |
| <b>Operating Revenues</b>                              |                    |                   |
| Investment management fees                             | \$ 831,890         | \$ 687,439        |
| Underwriting and distribution fees                     | 509,773            | 414,879           |
| Shareholder servicing fees                             | 67,565             | 64,272            |
| Consolidated sponsored investment products income, net | 837                | 278               |
| Other, net   | 17,750             | 14,584            |
| <b>Total operating revenues</b>                        | <b>1,427,815</b>   | <b>1,181,452</b>  |
| <b>Operating Expenses</b>                              |                    |                   |
| Underwriting and distribution                          | 478,051            | 380,077           |
| Compensation and benefits                              | 251,016            | 218,480           |
| Information systems, technology and occupancy          | 75,063             | 73,895            |
| Advertising and promotion                              | 34,861             | 30,337            |
| Amortization of deferred sales commissions             | 33,747             | 32,002            |
| Amortization of intangible assets                      | 2,668              | 4,353             |
| Other  | 44,339             | 37,722            |
| <b>Total operating expenses</b>                        | <b>919,745</b>     | <b>776,866</b>    |
| Operating income                                       | 508,070            | 404,586           |
| <b>Other Income (Expenses)</b>                         |                    |                   |
| Consolidated sponsored investment products gains, net  | 30,286             | 10,814            |
| Investment and other income, net                       | 71,109             | 32,366            |
| Interest expense                                       | (6,122)            | (9,188)           |
| Other income, net                                      | 95,273             | 33,992            |
| Income before taxes on income                          | 603,343            | 438,578           |
| Taxes on income  | 176,543            | 120,609           |
| <b>Net Income</b>                                      | <b>\$ 426,800</b>  | <b>\$ 317,969</b> |
| <b>Earnings per Share</b>                              |                    |                   |
| Basic  | \$ 1.69            | \$ 1.26           |
| Diluted  | 1.67               | 1.21              |
| <b>Dividends per Share</b>                             | <b>\$ 0.15</b>     | <b>\$ 0.12</b>    |

See Notes to Condensed Consolidated Financial Statements.



**FRANKLIN RESOURCES, INC.****Condensed Consolidated Balance Sheets****Unaudited**

|   | December 31,        | September 30,       |
|---|---------------------|---------------------|
| <i>(in thousands)</i>                     | 2006                | 2006                |
| <b>Assets</b>                             |                     |                     |
| <b>Current Assets</b>                     |                     |                     |
| Cash and cash equivalents                 | \$ 3,683,267        | \$ 3,310,545        |
| Receivables                               | 689,187             | 628,812             |
| Investment securities, trading            | 418,407             | 382,053             |
| Investment securities, available-for-sale | 584,524             | 552,211             |
| Deferred taxes and other                  | 91,186              | 95,980              |
| Total current assets                      | 5,466,571           | 4,969,601           |
| <b>Banking/Finance Assets</b>             |                     |                     |
| Cash and cash equivalents                 | 322,782             | 302,590             |
| Loans held for sale, net                  | 193,184             | 391,734             |
| Loans receivable, net                     | 226,301             | 253,370             |
| Investment securities, available-for-sale | 137,581             | 171,632             |
| Other                                     | 33,790              | 29,567              |
| Total banking/finance assets              | 913,638             | 1,148,893           |
| <b>Non-Current Assets</b>                 |                     |                     |
| Investments, other                        | 500,571             | 471,553             |
| Deferred sales commissions                | 267,349             | 274,869             |
| Property and equipment, net               | 511,659             | 506,291             |
| Goodwill                                  | 1,404,726           | 1,406,825           |
| Other intangible assets, net              | 571,477             | 574,633             |
| Receivable from banking/finance group     |                     | 82,329              |
| Other                                     | 27,485              | 64,865              |
| Total non-current assets                  | 3,283,267           | 3,381,365           |
| <b>Total Assets</b>                       | <b>\$ 9,663,476</b> | <b>\$ 9,499,859</b> |

[Table continued on next page]

See Notes to Condensed Consolidated Financial Statements.

## FRANKLIN RESOURCES, INC.

## Condensed Consolidated Balance Sheets

## Unaudited

[Table continued from previous page]

|  | December 31,        | September 30,       |
|--|---------------------|---------------------|
|  | 2006                | 2006                |
| <i>(dollars in thousands, except share data)</i>   |                     |                     |
| <b>Liabilities and Stockholders Equity</b>   |                     |                     |
| <b>Current Liabilities</b>   |                     |                     |
| Compensation and benefits  | \$ 166,472          | \$ 276,998          |
| Commercial paper   | 168,099             | 168,063             |
| Accounts payable and accrued expenses  | 188,941             | 180,690             |
| Commissions  | 234,619             | 210,996             |
| Income taxes   | 151,502             | 97,936              |
| Other  | 25,638              | 27,513              |
| Total current liabilities  | 935,271             | 962,196             |
| <b>Banking/Finance Liabilities</b>   |                     |                     |
| Deposits   | 531,243             | 548,907             |
| Payable to parent  |                     | 82,329              |
| Variable Funding Notes   | 118,605             | 232,330             |
| Other  | 48,537              | 44,821              |
| Total banking/finance liabilities  | 698,385             | 908,387             |
| <b>Non-Current Liabilities</b>   |                     |                     |
| Long-term debt   | 612,983             | 627,919             |
| Deferred taxes   | 183,520             | 211,588             |
| Other  | 9,635               | 9,245               |
| Total non-current liabilities  | 806,138             | 848,752             |
| Total liabilities  | 2,439,794           | 2,719,335           |
| <b>Minority Interest</b>   | 106,345             | 95,796              |
| <b>Commitments and Contingencies (Note 10)</b>   |                     |                     |
| <b>Stockholders Equity</b>   |                     |                     |
| Preferred stock, \$1.00 par value, 1,000,000 shares authorized; none issued  |                     |                     |
| Common stock, \$0.10 par value, 1,000,000,000 shares authorized; 253,551,610 and 253,249,420 shares issued and outstanding, for December 31, 2006 and September 30, 2006 | 25,355              | 25,325              |
| Capital in excess of par value   | 178,461             | 185,583             |
| Retained earnings  | 6,719,961           | 6,333,843           |
| Accumulated other comprehensive income   | 193,560             | 139,977             |
| Total stockholders equity  | 7,117,337           | 6,684,728           |
| <b>Total Liabilities and Stockholders Equity</b>   | <b>\$ 9,663,476</b> | <b>\$ 9,499,859</b> |

See Notes to Condensed Consolidated Financial Statements.

## FRANKLIN RESOURCES, INC.

## Condensed Consolidated Statements of Cash Flows

## Unaudited

| <i>(in thousands)</i>  | Three Months Ended   |            |
|--|----------------------|------------|
|  | December 31,<br>2006 | 2005       |
| <b>Net Income</b>  | \$ 426,800           | \$ 317,969 |
| <i>Adjustments to reconcile net income to net cash provided by operating activities:</i> |                      |            |
| Depreciation and amortization  | 52,539               | 53,767     |
| Equity in net income of affiliated companies   | (17,290)             | (1,764)    |
| Net (gains) losses on disposal of assets   | (8,055)              | 3,583      |
| Excess tax benefit from stock-based compensation arrangements                            | (33,000)             | (8,906)    |
| <i>Changes in operating assets and liabilities:</i>                                      |                      |            |
| (Increase) decrease in receivables, prepaid expenses and other                           | (28,966)             | 15,033     |
| Originations of loans held for sale, net   | (157,223)            | (89,287)   |
| Proceeds from securitization of loans held for sale                                      | 354,974              | 351,392    |
| Increase in trading securities, net  | (36,353)             | (29,204)   |
| Advances of deferred sales commissions, net  | (30,097)             | (25,220)   |
| Decrease in provision for governmental investigations, proceedings and actions, net      | (580)                | (53,306)   |
| Increase in deferred income taxes and taxes payable                                      | 106,651              | 85,299     |
| Increase in commissions payable  | 23,624               | 4,225      |
| (Decrease) increase in other liabilities   | (5,290)              | 20,594     |
| Stock-based compensation and increase in accrued compensation and benefits               | (96,463)             | (97,558)   |
| Net cash provided by operating activities  | 551,271              | 546,617    |
| Purchase of investments  | (125,726)            | (62,694)   |
| Liquidation of investments   | 108,198              | 194,541    |
| Purchase of banking/finance investments  | (179)                | (6,684)    |
| Liquidation of banking/finance investments   | 33,778               | 32,319     |
| Net origination of loans receivable  | 27,291               | 1,262      |
| Net additions of property and equipment  | (17,589)             | (11,036)   |
| Disposition of subsidiaries, net of cash   | (2,414)              |            |
| Net cash provided by investing activities  | 23,359               | 147,708    |
| (Decrease) increase in bank deposits   | (17,663)             | 16,100     |
| Exercise of common stock options   | 16,438               | 37,577     |
| Dividends paid on common stock   | (30,386)             | (25,268)   |
| Purchase of common stock   | (73,715)             | (44,999)   |
| Excess tax benefits from stock-based compensation arrangements                           | 33,000               | 8,906      |
| Increase in debt   | 122,200              | 27,251     |
| Payments on debt   | (250,581)            | (268,124)  |
| Minority interest  | 18,991               | 28,426     |
| Net cash used in financing activities  | (181,716)            | (220,131)  |
| Increase in cash and cash equivalents  | 392,914              | 474,194    |
| Cash and cash equivalents, beginning of period   | 3,613,135            | 3,152,159  |



**Cash and Cash Equivalents, End of Period**

**\$ 4,006,049    \$ 3,626,353**

[Table continued on next page]

See Notes to Condensed Consolidated Financial Statements.

**FRANKLIN RESOURCES, INC.****Condensed Consolidated Statements of Cash Flows****Unaudited**

[Table continued from previous page]

|   | <b>Three Months Ended</b> |                     |
|---|---------------------------|---------------------|
|   | <b>December 31,</b>       |                     |
| <i>(in thousands)</i>   | <b>2006</b>               | <b>2005</b>         |
| <b>Components of Cash and Cash Equivalents</b>  |                           |                     |
| Cash and cash equivalents, beginning of period:   |                           |                     |
| Current assets  | \$ 3,310,545              | \$ 3,076,318        |
| Banking/finance assets  | 302,590                   | 75,841              |
| <b>Total</b>  | <b>\$ 3,613,135</b>       | <b>\$ 3,152,159</b> |
| Cash and cash equivalents, end of period:   |                           |                     |
| Current assets  | \$ 3,683,267              | \$ 3,332,052        |
| Banking/finance assets  | 322,782                   | 294,301             |
| <b>Total</b>  | <b>\$ 4,006,049</b>       | <b>\$ 3,626,353</b> |
| <b>Supplemental Disclosure of Non-Cash Information</b>                                      |                           |                     |
| Value of common stock issued on conversion of zero coupon convertible senior notes          | \$                        | \$ 296,380          |
| Total assets related to the net deconsolidation of certain sponsored investment products    | (3,298)                   | (27,180)            |
| Total liabilities related to the net consolidation of certain sponsored investment products | 10,139                    | 10,453              |

See Notes to Condensed Consolidated Financial Statements.

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**FRANKLIN RESOURCES, INC.**

**Notes to Condensed Consolidated Financial Statements**

**December 31, 2006**

**(Unaudited)**

**Note 1- Basis of Presentation**

We have prepared these unaudited interim financial statements of Franklin Resources, Inc. (the Company or we ) and its consolidated subsidiaries (collectively Franklin Templeton Investments ) in accordance with the instructions to Form 10-Q and the rules and regulations of the U.S. Securities and Exchange Commission (the SEC ). Under these rules and regulations, we have shortened or omitted some information and footnote disclosures normally included in financial statements prepared under generally accepted accounting principles. We believe that we have made all adjustments necessary for a fair statement of the financial position and the results of operations for the periods shown. All adjustments are normal and recurring. You should read these financial statements together with our audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006. Certain amounts for the comparative prior fiscal year periods have been reclassified to conform to the financial presentation for and at the period ended December 31, 2006. In addition, as more fully described in our audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006, we have made certain revisions to the Consolidated Statement of Cash Flow for the three months ended December 31, 2005.

**Note 2 - New Accounting Standards**

In November 2006, the Financial Accounting Standards Board (the FASB ) ratified the consensus reached by the Emerging Issues Task Force ( EITF ) in EITF Abstracts Issue No. 06-9, Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee ( EITF 06-9 ). EITF 06-9 requires certain disclosures whenever a change is made to modify or eliminate the time lag used for recording results of consolidated entities or equity method investees that have a different fiscal year end than a parent. EITF 06-9 is effective for changes in the time lag occurring in the interim or annual reporting periods beginning after November 29, 2006. We will adopt EITF 06-9 in the three months ending March 31, 2007. The adoption of EITF 06-9 is not expected to have a material impact on our Consolidated Financial Statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132-R ( SFAS 158 ). SFAS 158 requires employers to recognize the funded status of defined benefit pension and other postretirement benefit plans as an asset or liability. SFAS 158 is effective as of the end of fiscal years ending after December 15, 2006. The adoption of SFAS 158 is not expected to materially impact our Consolidated Financial Statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require new fair value measurements, but provides guidance on how to measure fair value by establishing a fair value hierarchy used to classify the source of the information. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We have not determined the impact that SFAS 157 will have on our Consolidated Financial Statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 requires an analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. SAB 108 is effective for the annual financial statements covering the first fiscal year ending after November 15, 2006. We have not determined the impact that SAB 108 will have on our Consolidated Financial Statements.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ), which clarifies the accounting for tax positions taken or expected to be taken in a tax return. FIN 48 provides guidance on the measurement, recognition, classification and disclosure of tax positions, along with accounting for related interest and penalties. FIN 48 is effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to retained earnings. We have not determined the impact that FIN 48 will have on our Consolidated Financial Statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 ( SFAS 156 ), which provides some relief for servicers that use derivatives to economically hedge fluctuations in the fair value of their servicing rights and changes how gains and losses are computed in certain transfers or securitizations. SFAS

156 revised the accounting for servicing assets and obligations

associated with financial assets that are acquired or disposed of. SFAS 156 was effective for fiscal years beginning after September 15, 2006. The adoption of SFAS 156 in the three months ended December 31, 2006 did not have a material impact on our Consolidated Financial Statements.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 ( SFAS 155 ), which resolves issues addressed in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133 and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 was effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year beginning after September 15, 2006. The adoption of SFAS 155 in the three months ended December 31, 2006 did not have a material impact on our Consolidated Financial Statements.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS 154 ), which changes the requirement for the accounting and reporting of a change in accounting principle. SFAS 154 eliminates the requirement in Accounting Principles Board Opinion No. 20, Accounting Changes, to include the cumulative effect of changes in accounting principle in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, SFAS 154 requires that changes in accounting principles are retrospectively applied, unless directed otherwise by a new pronouncement. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 in the three months ended December 31, 2006 did not have a material impact on our Consolidated Financial Statements.

### Note 3 - Comprehensive Income

The following table computes comprehensive income.

|  | Three Months Ended |                   |
|--|--------------------|-------------------|
|  | December 31,       |                   |
|  | 2006               | 2005              |
| <i>(in thousands)</i>                          |                    |                   |
| Net income                                     | \$ 426,800         | \$ 317,969        |
| Net unrealized gain on investments, net of tax | 32,349             | 3,887             |
| Currency translation adjustments               | 19,403             | (6,247)           |
| Other  | 1,831              | (571)             |
| <b>Comprehensive Income</b>                    | <b>\$ 480,383</b>  | <b>\$ 315,038</b> |

### Note 4 - Earnings per Share

We computed earnings per share as follows:

|   | Three Months Ended |                |
|---|--------------------|----------------|
|   | December 31,       |                |
|   | 2006               | 2005           |
| <i>(in thousands, except per share data)</i>  |                    |                |
| Net income  | \$ 426,800         | \$ 317,969     |
| Add: interest and discount amortization on zero coupon convertible senior notes, net of taxes |                    | 2,466          |
| <b>Adjusted net income</b>  | <b>426,800</b>     | <b>320,435</b> |
| Weighted-average shares outstanding basic   | 252,400            | 253,208        |
| Incremental shares from assumed conversions:  |                    |                |
| Common stock options and nonvested stock awards and stock unit awards                         | 3,147              | 4,152          |
| Zero coupon convertible senior notes  |                    | 7,706          |

|  |                |                |
|--|----------------|----------------|
| <b>Weighted-Average Shares Outstanding Diluted</b> | <b>255,547</b> | <b>265,066</b> |
|--|----------------|----------------|

**Earnings per Share**

|         |         |         |
|---------|---------|---------|
| Basic   | \$ 1.69 | \$ 1.26 |
| Diluted | 1.67    | 1.21    |

For the three months ended December 31, 2006 and 2005, approximately 674.8 thousands and 55.1 thousands nonvested shares related to grants of stock awards and stock unit awards were excluded from the computation of diluted earnings per share because their effect would have been antidilutive.

**Note 5 - Cash and Cash Equivalents**

We disclose cash and cash equivalents as separate components of current assets and in banking/finance assets in our Condensed Consolidated Balance Sheets. Cash and cash equivalents consisted of the following:

| <i>(in thousands)</i>   | <b>December 31, 2006</b> | <b>September 30, 2006</b> |
|---|--------------------------|---------------------------|
| Cash and due from banks   | \$ 473,109               | \$ 418,142                |
| Federal funds sold and securities purchased under agreements to resell                  | 202,123                  | 187,071                   |
| Securities of U.S. federal agencies, money market mutual funds, time deposits and other | 3,330,817                | 3,007,922                 |
| <b>Total</b>  | <b>\$ 4,006,049</b>      | <b>\$ 3,613,135</b>       |

Federal Reserve Board regulations require reserve balances on deposits to be maintained with the Federal Reserve Banks by banking subsidiaries. The required reserve balances were \$2.6 million at December 31, 2006 and \$4.0 million at September 30, 2006.

**Note 6 - Consolidated Sponsored Investment Products**

The following tables present the effect on our consolidated results of operations and financial position of the consolidation and deconsolidation activity related to sponsored investment products accounted for under FASB Statement of Financial Accounting Standards No. 94,

Consolidation of All Majority-Owned Subsidiaries an amendment of ARB No. 51, with related amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12, and FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46-R).

| <i>(in thousands)</i>                                  | <b>Three Months Ended December 31, 2006</b> |                   |                     |
|--|---|-------------------|---------------------|
|  | <b>Sponsored</b>                            |                   |                     |
|  | <b>Before</b>                               | <b>Investment</b> |                     |
|  | <b>Consolidation</b>                        | <b>Products</b>   | <b>Consolidated</b> |
| <b>Operating Revenues</b>                              |   |                   |                     |
| Investment management fees                             | \$ 835,380                                  | \$ (3,490)        | \$ 831,890          |
| Underwriting and distribution fees                     | 510,072                                     | (299)             | 509,773             |
| Shareholder servicing fees                             | 67,572                                      | (7)               | 67,565              |
| Consolidated sponsored investment products income, net |   | 837               | 837                 |
| Other, net   | 17,750                                      |                   | 17,750              |
| <b>Total operating revenues</b>                        | <b>1,430,774</b>                            | <b>(2,959)</b>    | <b>1,427,815</b>    |
| <b>Operating Expenses</b>                              | <b>919,745</b>                              |                   | <b>919,745</b>      |
| <b>Operating income</b>                                | <b>511,029</b>                              | <b>(2,959)</b>    | <b>508,070</b>      |
| <b>Other Income (Expenses)</b>                         |   |                   |                     |
| Consolidated sponsored investment products gains, net  |   | 30,286            | 30,286              |
| Investment and other income (expenses), net            | 76,572                                      | (5,463)           | 71,109              |
| Interest expense                                       | (6,122)                                     |                   | (6,122)             |
| <b>Other income, net</b>                               | <b>70,450</b>                               | <b>24,823</b>     | <b>95,273</b>       |
| <b>Income before taxes on income</b>                   | <b>581,479</b>                              | <b>21,864</b>     | <b>603,343</b>      |
| <b>Taxes on income</b>                                 | <b>170,454</b>                              | <b>6,089</b>      | <b>176,543</b>      |
| <b>Net Income</b>                                      | <b>\$ 411,025</b>                           | <b>\$ 15,775</b>  | <b>\$ 426,800</b>   |





|  | December 31, 2006   |                   |                     |
|--|---------------------|-------------------|---------------------|
|  | Sponsored           |                   |                     |
|  | Before              | Investment        |                     |
| <i>(in thousands)</i>                            | Consolidation       | Products          | Consolidated        |
| <b>Assets</b>                                    |                     |                   |                     |
| Current assets                                   | \$ 5,292,634        | \$ 173,937        | \$ 5,466,571        |
| Banking/finance assets                           | 913,638             |                   | 913,638             |
| Non-current assets                               | 3,318,701           | (35,434)          | 3,283,267           |
| <b>Total Assets</b>                              | <b>\$ 9,524,973</b> | <b>\$ 138,503</b> | <b>\$ 9,663,476</b> |
| <b>Liabilities and Stockholders Equity</b>       |                     |                   |                     |
| Current liabilities                              | \$ 868,168          | \$ 67,103         | \$ 935,271          |
| Banking/finance liabilities                      | 698,385             |                   | 698,385             |
| Non-current liabilities                          | 825,081             | (18,943)          | 806,138             |
| <b>Total Liabilities</b>                         | <b>2,391,634</b>    | <b>48,160</b>     | <b>2,439,794</b>    |
| Minority interest                                | 24,603              | 81,742            | 106,345             |
| Total stockholders equity                        | 7,108,736           | 8,601             | 7,117,337           |
| <b>Total Liabilities and Stockholders Equity</b> | <b>\$ 9,524,973</b> | <b>\$ 138,503</b> | <b>\$ 9,663,476</b> |

Sales and redemptions of shares of our consolidated sponsored investment products are a component of the change in minority interest included in financing activities in our Condensed Consolidated Statements of Cash Flows.

#### Note 7 - Securitization of Loans Receivable

From time to time, we enter into automobile loan securitization transactions with qualified special purpose entities and record these transactions as sales. The following table shows details of automobile loan securitization transactions.

|  | Three Months Ended   |               |
|--|----------------------|---------------|
|  | December 31,<br>2006 | 2005          |
| <i>(in thousands)</i>                            |                      |               |
| Net sale proceeds                                | \$ 353,508           | \$ 348,332    |
| Less: net carrying amount of loans held for sale | 351,013              | 348,169       |
| <b>Pre-Tax Gain</b>                              | <b>\$ 2,495</b>      | <b>\$ 163</b> |

When we sell automobile loans in a securitization transaction, we record an interest-only strip receivable. The interest-only strip receivable represents our contractual right to receive interest from the pool of securitized loans after the payment of required amounts to holders of the securities and certain other costs associated with the securitization. Automobile loans sold in a securitization transaction in the three months ended December 31, 2006, included loans held by a special purpose statutory Delaware trust (the Trust) that was organized in fiscal year 2005 to hold our loans held for sale and issue notes under a variable funding note warehouse credit facility. Directly and through the Trust, which is consolidated in our results of operations, we also enter into interest-rate swap agreements, accounted for as freestanding derivatives, intended to mitigate the interest risk between the fixed interest rate on the pool of automobile loans and the floating interest rate being paid under the variable funding note warehouse credit facility until the securitization and sale of the related loans. The fair value of interest-rate swaps outstanding at December 31, 2006 of approximately \$18.3 thousand was reflected as an asset on the Condensed Consolidated Balance Sheet. These interest rate swaps, with a notional value of \$124.5 million, mitigate the interest risk between the fixed interest rate on the pool of automobile loans that were funded subsequent to the securitization transaction that occurred in the three months ended December 31, 2006 and the floating interest rate being paid under the variable funding note warehouse credit facility.

We generally estimate fair value based on the present value of future expected cash flows. The key assumptions used in the present value calculations of our securitization transactions at the date of securitization were as follows:

|   | Three Months Ended |       |
|---|--------------------|-------|
|   | December 31,       |       |
|   | 2006               | 2005  |
| Excess cash flow discount rate (annual rate)        | 12.0%              | 12.0% |
| Cumulative life loss rate                           | 4.0%               | 3.2%  |
| Pre-payment speed assumption (average monthly rate) | 1.6%               | 1.6%  |

We determined these assumptions using data from comparable transactions, historical information and management's estimate. Interest-only strips receivable are generally restricted assets and subject to limited recourse provisions.

We generally estimate the fair value of the interest-only strips at each period-end based on the present value of future expected cash flows, consistent with the methodology used at the date of securitization. The following shows the carrying value and the sensitivity of the interest-only strips receivable to hypothetical adverse changes in the key economic assumptions used to measure fair value:

| <i>(dollar amounts in thousands)</i>                                 | December 31, 2006 | September 30, 2006 |
|--|-------------------|--------------------|
| <i>Carrying amount/fair value of interest-only strips receivable</i> | \$ 22,132         | \$ 10,559          |
| <i>Excess cash flow discount rate (annual rate)</i>                  | 12.0%             | 12.0%              |
| Impact on fair value of 10% adverse change                           | \$ (276)          | \$ (148)           |
| Impact on fair value of 20% adverse change                           | (543)             | (293)              |
| <i>Cumulative life loss rate</i>                                     | 3.8%              | 3.3%               |
| Impact on fair value of 10% adverse change                           | \$ (1,247)        | \$ (2,093)         |
| Impact on fair value of 20% adverse change                           | (2,273)           | (4,185)            |
| <i>Pre-payment speed assumption (average monthly rate)</i>           | 1.6%              | 1.6%               |
| Impact on fair value of 10% adverse change                           | \$ (1,284)        | \$ (1,483)         |
| Impact on fair value of 20% adverse change                           | (1,954)           | (3,082)            |

Actual future market conditions may differ materially. Accordingly, this sensitivity analysis should not be considered our projection of future events or losses.

We retain servicing responsibilities for automobile loan securitizations and receive annual servicing fees ranging from 1% to 2% of the loans securitized for services that we provide to the securitization trusts. We have not recognized a servicing asset or liability under the provisions of FASB Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125, as amended by SFAS 156 because the benefits of servicing are just adequate to compensate us for our servicing responsibilities.

The following table is a summary of cash flows received from and paid to securitization trusts.

|  | Three Months Ended |          |
|--|--------------------|----------|
|  | December 31,       |          |
|  | 2006               | 2005     |
| <i>(in thousands)</i>                    |                    |          |
| Servicing fees received                  | \$ 4,081           | \$ 2,628 |
| Interest-only strips cash flows received | 3,189              | 5,067    |
| Purchase of loans from trusts            | (10,577)           | (23,597) |

Amounts payable to the trustee related to loan principal and interest collected on behalf of the trusts of \$26.7 million at December 31, 2006 and \$40.2 million at September 30, 2006 are included in other banking/finance liabilities.

The following table shows details of the loans we manage that are held by securitization trusts.

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*(in thousands)*

|  | <b>December 31, 2006</b> | <b>September 30, 2006</b> |
|--|--------------------------|---------------------------|
| Principal amount of loans                          | \$ 751,449               | \$ 514,837                |
| Principal amount of loans 30 days or more past due | 17,286                   | 11,438                    |

Net charge-offs on the securitized loan portfolio were \$2.9 million and \$3.3 million for the three months ended December 31, 2006 and 2005.

**Note 8 - Goodwill and Other Intangible Assets**

Goodwill and indefinite-lived intangible assets, including those acquired before initial application of FASB Statement of Financial Accounting Standards No. 141, Business Combinations, and FASB Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142), are not amortized but are tested for impairment at least annually.

All of our goodwill and intangible assets relate to our investment management and other services operating segment. Non-amortized intangible assets represent the value of management contracts related to certain of our sponsored investments products that are indefinite-lived.

During the quarter ended December 31, 2006, we completed our most recent annual impairment testing of goodwill and indefinite-lived intangible assets under the guidance set out in SFAS 142 and we determined that there was no impairment to these assets as of October 1, 2006.

During the three months ended March 31, 2006, Fiduciary Trust Company International (Fiduciary Trust), a subsidiary of the Company, implemented a plan of reorganization designed to emphasize its distinct high net-worth brand and to pursue further integration opportunities with Franklin Templeton Investments for its institutional business line. These changes to Fiduciary Trust's business required us to review the carrying value of acquired customer base intangible assets of Fiduciary Trust. As a result of these changes, we recorded a \$68.4 million non-cash impairment charge to the customer base definite-lived intangible assets of Fiduciary Trust in the three months ended March 31, 2006.

Intangible assets, other than goodwill were as follows:

|  | December 31, 2006 |                     |                   |
|--|-------------------|---------------------|-------------------|
|  | Gross             |                     | Net               |
|  | Carrying          | Accumulated         | Carrying          |
| <i>(in thousands)</i>                  | Amount            | Amortization        | Amount            |
| <b>Amortized intangible assets</b>     |                   |                     |                   |
| Customer base                          | \$ 165,318        | \$ (84,686)         | \$ 80,632         |
| Other                                  | 35,018            | (25,953)            | 9,065             |
|  | 200,336           | (110,639)           | 89,697            |
| <b>Non-amortized intangible assets</b> |                   |                     |                   |
| Investment management contracts        | 481,780           |                     | 481,780           |
| <b>Total</b>                           | <b>\$ 682,116</b> | <b>\$ (110,639)</b> | <b>\$ 571,477</b> |

|  | September 30, 2006 |                     |                   |
|--|--------------------|---------------------|-------------------|
|  | Gross              |                     | Net               |
|  | Carrying           | Accumulated         | Carrying          |
| <i>(in thousands)</i>                  | Amount             | Amortization        | Amount            |
| <b>Amortized intangible assets</b>     |                    |                     |                   |
| Customer base                          | \$ 165,606         | \$ (82,616)         | \$ 82,990         |
| Other                                  | 35,018             | (25,473)            | 9,545             |
|  | 200,624            | (108,089)           | 92,535            |
| <b>Non-amortized intangible assets</b> |                    |                     |                   |
| Investment management contracts        | 482,098            |                     | 482,098           |
| <b>Total</b>                           | <b>\$ 682,722</b>  | <b>\$ (108,089)</b> | <b>\$ 574,633</b> |

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The gross and net carrying amounts of certain of our intangible assets are subject to foreign currency movements because they are denominated in currencies other than the U.S. dollar.

The change in the carrying value of goodwill was as follows:

*(in thousands)*

|                                     |                     |
|-------------------------------------|---------------------|
| Balance at September 30, 2006       | \$ 1,406,825        |
| Foreign currency movements          | (2,099)             |
| <b>Balance at December 31, 2006</b> | <b>\$ 1,404,726</b> |

Estimated amortization expense related to definite-lived intangible assets for each of the next 5 fiscal years is as follows:

(in thousands)

for the Fiscal Years

Ending September 30,

|      |           |
|------|-----------|
| 2007 | \$ 10,666 |
| 2008 | 10,594    |
| 2009 | 10,595    |
| 2010 | 10,595    |
| 2011 | 10,459    |

**Note 9 - Debt**

Outstanding debt consisted of the following:

(in thousands)

|                         | December 31, 2006 | September 30, 2006  |
|-------------------------|-------------------|---------------------|
| <b>Current</b>          |                   |                     |
| Federal funds purchased | \$ 3,000          | \$                  |
| Variable Funding Notes  | 118,605           | 232,330             |
| Commercial paper        | 168,099           | 168,063             |
|                         | 289,704           | 400,393             |
| <b>Non-Current</b>      |                   |                     |
| Medium Term Notes       | 420,000           | 420,000             |
| Other                   | 192,983           | 207,919             |
|                         | 612,983           | 627,919             |
| <b>Total Debt</b>       | <b>\$ 902,687</b> | <b>\$ 1,028,312</b> |

Federal funds purchased, when outstanding, are included in other liabilities of the banking/finance operating segment.

Our banking/finance segment finances its automotive lending business primarily by issuing variable funding notes (the Variable Funding Notes ) under a one-year revolving \$250.0 million variable funding note warehouse credit facility, originally entered into in March 2005, and subsequently extended for an additional one-year term in March 2006. The Variable Funding Notes are payable to certain administered conduits and are secured by cash and a pool of automobile loans that meet or are expected to meet certain eligibility requirements. Credit enhancements for the Variable Funding Notes require us to provide, as collateral, loans held for sale with a fair value in excess of the principal amount of the Variable Funding Notes, as well as to hold in trust additional cash balances to cover certain shortfalls. In addition, we provide a payment provider commitment in an amount not to exceed 4.66% of the pool balance. We also enter into interest-rate swap agreements, accounted for as freestanding derivatives, intended to mitigate the interest-rate risk between the fixed interest rate on the pool of automobile loans and the floating interest rate being paid on the Variable Funding Notes. We expect to extend or replace the variable funding warehouse credit facility upon the expiration of the current facility.

In April 2003, we completed the sale of five-year senior notes due April 15, 2008 totaling \$420.0 million (the Medium Term Notes ). The Medium Term Notes, which were offered to qualified institutional buyers only, carry an interest rate of 3.7% and are not redeemable prior to maturity by either the note holders or us. Interest payments are due semi-annually.

Other long-term debt primarily relates to deferred commission liabilities recognized in relation to U.S. deferred commission assets originally financed through a sale to Lightning Finance Company Limited ( LFL ), a company in which we hold a 49% ownership interest. Historically, our Class B and certain of our Class C deferred commission assets ( DCA ) arising from our U.S., Canadian and European operations have been financed through sales to or other arrangements with LFL. In December 2005, LFL transferred substantially all of its DCA to Lightning Asset Finance Limited ( LAFL ), an Irish special purpose vehicle formed in December 2005, in which we also hold a 49% ownership interest. LAFL was formed for the sole purpose of acquiring and holding substantially all of the DCA owned by LFL as of December 29, 2005. The holder of

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the 51% ownership interests in both LFL and LAFL is a subsidiary of an international banking institution which is not affiliated with Franklin Templeton Investments. Due to our significant interest in both LFL and LAFL, we continue to carry on our balance sheet the DCA and deferred commission liabilities related to the DCA originally sold to LFL by Franklin/Templeton Distributors, Inc. ( FTDI ) until these assets are amortized or sold by LAFL. Neither we nor our distribution subsidiaries retain any direct ownership interest in the DCA sold, and, therefore, the sold DCA are not available to satisfy claims of our creditors or those of our distribution subsidiaries.

At December 31, 2006, we had \$420.0 million available under a Five Year Facility Credit Agreement with certain banks and financial institutions expiring in the fiscal year ending September 30, 2010, \$300.0 million of debt and equity securities available to be issued under a shelf registration statement filed with the SEC and \$330.0 million of commercial paper available for issuance under a \$500.0 million private placement. In addition, at December 31, 2006, our banking/finance operating segment had \$462.0 million in available uncommitted short-term bank lines under the Federal Reserve Funds system, the Federal Reserve Bank discount window, and Federal Home Loan Bank short-term borrowing capacity.

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## Note 10 - Commitments and Contingencies

### *Guarantees*

Under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, we are required to recognize, in our financial statements, a liability for the fair value of any guarantees issued or modified after December 31, 2002 as well as make additional disclosures about existing guarantees.

In relation to the automobile loan securitization transactions that we have entered into with a number of qualified special purpose entities, we are obligated to cover shortfalls in amounts due to the holders of the notes up to certain levels as specified under the related agreements. As of December 31, 2006, the maximum potential amount of future payments related to these obligations was \$34.9 million and the fair value of obligations arising from automobile securitization transactions entered into subsequent to December 31, 2002 reflected on our Condensed Consolidated Balance Sheet at December 31, 2006 was not significant.

At December 31, 2006, our banking/finance operating segment had issued financial standby letters of credit totaling \$1.3 million which beneficiaries would be able to draw upon in the event of non-performance by our customers, primarily in relation to lease and lien obligations of these banking customers. These standby letters of credit were secured by marketable securities with a fair value of \$2.4 million as of December 31, 2006.

### *Legal Proceedings*

As previously reported, the Company and certain of its subsidiaries, and in some instances, certain of the Franklin Templeton mutual funds (the *Funds*), current and former officers, employees, and Company and/or Fund directors, have been named in multiple lawsuits in different federal courts, alleging violations of federal securities and state laws. Specifically, the lawsuits claim breach of duty with respect to alleged arrangements to permit market timing and/or late trading activity, or breach of duty with respect to the valuation of the portfolio securities of certain Templeton Funds managed by certain of the Company's subsidiaries, allegedly resulting in market timing activity. The majority of these lawsuits duplicate, in whole or in part, the allegations asserted in the February 4, 2004 Massachusetts Administrative Complaint concerning one instance of market timing (the *Administrative Complaint*) and the SEC's findings regarding market timing in its August 2, 2004 Order (the *SEC Order*), both of which matters were previously reported. The lawsuits are styled as class actions, or derivative actions on behalf of either the named Funds or the Company, and seek, among other relief, monetary damages, restitution, removal of Fund trustees, directors, advisers, administrators, and distributors, rescission of management contracts and distribution plans under Rule 12b-1 promulgated under the Investment Company Act of 1940 ( *Rule 12b-1* ), and/or attorneys' fees and costs.

To date, more than 400 similar lawsuits against at least 19 different mutual fund companies have been filed in federal district courts throughout the country. Because these cases involve common questions of fact, the Judicial Panel on Multidistrict Litigation (the *Judicial Panel*) ordered the creation of a multidistrict litigation in the United States District Court for the District of Maryland, entitled *In re Mutual Funds Investment Litigation* (the *MDL*). The Judicial Panel then transferred similar cases from different districts to the MDL for coordinated or consolidated pretrial proceedings.

As of February 7, 2007, the following market timing lawsuits are pending against the Company and certain of its subsidiaries (and in some instances, name certain current and former officers, employees, Company and/or Fund directors, and/or Funds) and have been transferred to the MDL:

Kenerley v. Templeton Funds, Inc., et al., Case No. 03-770 GPM, filed on November 19, 2003 in the United States District Court for the Southern District of Illinois; Cullen v. Templeton Growth Fund, Inc., et al., Case No. 03-859 MJR, filed on December 16, 2003 in the United States District Court for the Southern District of Illinois and transferred to the United States District Court for the Southern District of Florida on March 29, 2004; Jaffe v. Franklin AGE High Income Fund, et al., Case No. CV-S-04-0146-PMP-RJJ, filed on February 6, 2004 in the United States District Court for the District of Nevada; Lum v. Franklin Resources, Inc., et al., Case No. C 04 0583 JSW, filed on February 11, 2004 in the United States District Court for the Northern District of California; Fischbein v. Franklin AGE High Income Fund, et al., Case No. C 04 0584 JSW, filed on February 11, 2004 in the United States District Court for the Northern District of California; Beer v. Franklin AGE High Income Fund, et al., Case No. 8:04-CV-249-T-26 MAP, filed on February 11, 2004 in the United States District Court for the Middle District of Florida; Bennett v. Franklin Resources, Inc., et al., Case No. CV-S-04-0154-HDM-RJJ, filed on February 12, 2004 in the United States District Court for the District of Nevada; Dukes v. Franklin AGE High Income Fund, et al., Case No. C 04 0598 MJJ, filed on February 12, 2004 in the United States District Court for the Northern District of California; McAlvey v. Franklin Resources, Inc., et al., Case No. C 04 0628 PJH, filed on February 13, 2004 in the United States District Court for the Northern District of California; Alexander v. Franklin AGE High Income Fund, et al., Case No. C 04 0639 SC, filed on February 17, 2004 in the United States District Court for the Northern District of California; Hugh Sharkey IRA/RO v. Franklin Resources, Inc., et al., Case No. 04 CV 1330, filed on February 18, 2004 in the United States District Court for the Southern District of New York; D'Alliessi v. Franklin AGE High Income Fund, et al., Case No. C 04 0865 SC, filed on March 3, 2004 in the United States District Court for the Northern District of California; Marcus v. Franklin Resources, Inc., et al., Case No. C 04 0901 JL, filed on



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March 5, 2004 in the United States District Court for the Northern District of California; Banner v. Franklin Resources, Inc., et al., Case No. C 04 0902 JL, filed on March 5, 2004 in the United States District Court for the Northern District of California; Denenberg v. Franklin Resources, Inc., et al., Case No. C 04 0984 EMC, filed on March 10, 2004 in the United States District Court for the Northern District of California; and

Page 14

Hertz v. Burns, et al., Case No. 04 CV 02489, filed on March 30, 2004 in the United States District Court for the Southern District of New York.

Plaintiffs in the MDL filed consolidated amended complaints on September 29, 2004. On February 25, 2005, defendants filed motions to dismiss. The Company's and its subsidiaries' motions are currently under submission with the court.

As also previously reported, various subsidiaries of the Company, as well as certain Templeton Fund registrants, have also been named in several class action lawsuits originally filed in state courts in Illinois, alleging breach of duty with respect to the valuation of the portfolio securities of certain Templeton Funds managed by such subsidiaries, and seeking, among other relief, monetary damages and attorneys' fees and costs, as follows:

Bradfish v. Templeton Funds, Inc., et al., Case No. 2003 L 001361, filed on October 3, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois; Woodbury v. Templeton Global Smaller Companies Fund, Inc., et al., Case No. 2003 L 001362, filed on October 3, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois; Kwiatkowski v. Templeton Growth Fund, Inc., et al., Case No. 03 L 785, filed on December 17, 2003 in the Circuit Court of the Twentieth Judicial Circuit, St. Clair County, Illinois; Parise v. Templeton Funds, Inc., et al., Case No. 2003 L 002049, filed on December 22, 2003 in the Circuit Court of the Third Judicial Circuit, Madison County, Illinois.

In April 2005, defendants removed these lawsuits to the United States District Court for the Southern District of Illinois. On July 12, 2005, the court dismissed with prejudice one of these lawsuits, Bradfish v. Templeton Funds, Inc., et al., and dismissed the remaining three lawsuits on August 25, 2005. Plaintiffs appealed the dismissals to the United States Court of Appeals for the Seventh Circuit (Bradfish v. Templeton Funds, Inc., et al., Case No. 05-3390, Woodbury v. Templeton Global Smaller Companies Fund, Inc., et al., Case No. 05-3559, Kwiatkowski v. Templeton Growth Fund, Inc., et al., Case No. 05-3558, Parise v. Templeton Funds, Inc., et al., Case No. 05-3586). On May 19, 2006, the Seventh Circuit affirmed the dismissals. Plaintiffs' subsequent requests to the Seventh Circuit for reconsideration were also denied. On November 13, 2006, plaintiffs filed a petition for certiorari to the United States Supreme Court. Defendants filed a brief in opposition on December 29, 2006.

In addition, Franklin Templeton Investments Corp., a subsidiary of the Company and the investment manager of Franklin Templeton's Canadian mutual funds, has been named in four class action market timing lawsuits in Canada, seeking, among other relief, monetary damages, an order barring any increase in management fees for a period of two years following judgment, and/or attorneys' fees and costs, as follows: Huneault v. AGF Funds, Inc., et al., Case No. 500-06-000256-046, filed on October 25, 2004 in the Superior Court for the Province of Quebec, District of Montreal; Heinrichs, et al. v. CI Mutual Funds, Inc., et al., Case No. 04-CV-29700, filed on December 17, 2004 in the Ontario Superior Court of Justice; Richardson v. Franklin Templeton Investments Corp., Case No. 05-CV-303069, filed on December 23, 2005 in the Ontario Superior Court of Justice; and Fischer, et al., v. IG Investment Management Ltd., et al. Case No. 06-CV-307599CP, filed on March 9, 2006 in the Ontario Superior Court of Justice.

As also previously reported, the Company and certain of its subsidiaries have been named in multiple lawsuits alleging violations of federal securities and state laws relating to marketing support payments and/or payment of allegedly excessive commissions, and/or advisory or distribution fees. All officers and directors originally named in these lawsuits have since been dismissed without prejudice pursuant to stipulated tolling agreements. These lawsuits are styled as class actions and/or derivative actions brought on behalf of certain Funds, and seek, among other relief, monetary damages, restitution, an accounting of all fees, commissions and soft dollar payments, declaratory relief, injunctive relief, and/or attorneys' fees and costs, and are as follows:

Stephen Alexander IRA v. Franklin Resources, Inc., et al., Case No. 04-982 JLL, filed on March 2, 2004 in the United States District Court for the District of New Jersey; Strigliabotti v. Franklin Resources, Inc., et al., Case No. C 04 0883 SI, filed on March 4, 2004 in the United States District Court for the Northern District of California; Tricarico v. Franklin Resources, Inc., et al., Case No. CV-04-1052 JAP, filed on March 4, 2004 in the United States District Court for the District of New Jersey; Wilcox v. Franklin Resources, Inc., et al., Case No. 04-2258 WHW, filed on May 12, 2004 in the United States District Court for the District of New Jersey; Wolbrink v. Franklin Resources, Inc., et al., Case No. 04-2430WHW, filed on May 25, 2004 in the United States District Court for the District of New Jersey; Alexander v. Franklin Resources, Inc., et al., Case No 06-7121 SI, filed on November 16, 2006 in the United States District Court for the Northern District of California; and Ulferts v. Franklin Resources, Inc., et al., Case No. 06-7847 SI filed on December 22, 2006 in the United States District Court for the Northern District of California.

The United States District Court for the District of New Jersey consolidated for pretrial purposes four of the above lawsuits (Stephen Alexander IRA, Tricarico, Wilcox, and Wolbrink) into a single master file entitled *In re Franklin Mutual Funds Fee Litigation* (Case No. 04-cv-982 (WJM)(RJH)). Following a September 9, 2005 order of dismissal with leave to amend certain claims, on March 10, 2006, plaintiffs in those lawsuits filed a second amended derivative consolidated complaint (the *Complaint*). Defendants moved to dismiss the *Complaint* on June 9, 2006. The parties completed briefing in September 2006, and the motion remains under submission with the court.



Management strongly believes that the claims made in each of the lawsuits identified above are without merit and intends to defend against them vigorously. The Company cannot predict with certainty, however, the eventual outcome of these lawsuits, nor whether they will have a material negative impact on the Company.

The Company is from time to time involved in litigation relating to claims arising in the normal course of business. Management is of the opinion that the ultimate resolution of such claims will not materially affect the Company's business, financial position, and results of operations.

#### *Other Commitments and Contingencies*

We have reviewed our interest in LFL and LAFL for consolidation under FIN 46-R. Based on our analysis, we determined that we hold a significant interest in both LFL and LAFL but that we are not the primary beneficiary of either company because we do not hold a majority of the risks and rewards of ownership. At December 31, 2006, LFL had approximately \$16.7 million in total assets and our exposure to loss related to LFL was limited to the carrying value of our investment, and interest and fees receivable totaling approximately \$1.0 million. At December 31, 2006, LAFL had approximately \$427.2 million in total assets and our maximum exposure to loss related to LAFL totaled approximately \$210.5 million. We recognized pre-tax loss of approximately \$0.3 million and \$0.8 million for our share of LFL's and LAFL's net losses for the three months ended December 31, 2006 and 2005. Due to our significant interest in both LFL and LAFL, we continue to carry on our balance sheet the DCA originally sold to LFL by FTDI until these assets are amortized or sold by LAFL. Neither we nor our distribution subsidiaries retain any direct ownership interest in the DCA sold, and therefore, the sold DCA are not available to satisfy claims of our creditors or those of our distribution subsidiaries.

At December 31, 2006, the total assets in sponsored investment products in which we held a significant interest under FIN 46-R were approximately \$865.8 million and our exposure to loss as a result of our interest in these products was \$196.0 million. These amounts represent our maximum exposure to loss and do not reflect our estimate of the actual losses that could result from adverse changes.

In July 2003, we renegotiated an agreement, originally signed in February 2001, to outsource the operation of our U.S. data centers, which includes responsibility for processing data and managing the centers. Beginning July 1, 2006, we can terminate the amended agreement by incurring a termination charge. The maximum termination charge payable will depend on the termination date of the amended agreement, the service levels before our termination of the agreement, costs incurred by our service provider to wind-down the services and costs associated with assuming equipment leases. As of December 31, 2006, we estimated that the termination fee payable in January 2007, not including costs associated with assuming equipment leases, would approximate \$10.6 million and would decrease each month thereafter, reaching a payment of approximately \$2.2 million in July 2008.

At December 31, 2006, our banking/finance operating segment had commitments to extend credit aggregating \$217.5 million, primarily under credit card lines.

We lease office space and equipment under long-term operating leases. At December 31, 2006, there were no material changes in leasing arrangements that would have a significant effect on future minimum lease payments reported in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

#### **Note 11 - Stock-Based Compensation**

Prior to October 1, 2005, we accounted for stock-based employee compensation plans according to the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations. Accordingly, compensation costs were not recognized for awards granted with no intrinsic value. Effective October 1, 2005, we adopted FASB Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R), using the modified prospective transition method. Under this transition method, beginning in the fiscal year ended September 30, 2006, compensation cost is recorded in relation to all stock-based payments granted prior to, but not yet vested at October 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). Results for prior periods have not been restated.

As a result of adopting SFAS 123R, income before income taxes for the three months ended December 31, 2006 and 2005 includes \$2.0 million and \$4.9 million of compensation costs that would not have been recognized under our previous accounting method for stock-based compensation. Net income for the three months ended December 31, 2006 and 2005 includes \$1.9 million and \$3.6 million of compensation costs, net of taxes that would not have been recognized under our previous accounting method for stock-based compensation, and, had we not adopted SFAS 123R, basic and diluted earnings per share for the three months ended December 31, 2006, and 2005 would have been \$0.01 higher.



Prior to the adoption of SFAS 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Consolidated Statements of Cash Flows. SFAS 123R requires the cash flows resulting from tax deductions in excess of the compensation cost recognized for stock-based payments ( excess tax benefits ) to be classified as financing cash flows. The excess tax benefit of \$33.0 million and \$8.9 million for the three months ended December 31, 2006 and 2005 that was classified as a financing cash inflow, would have been classified as an operating cash inflow if we had not adopted SFAS 123R.

We sponsor the Amended and Restated Annual Incentive Plan (the AIP ) and the 2002 Universal Stock Incentive Plan (the USIP ). Under the terms of the AIP, eligible employees may receive cash, equity awards and/or cash-settled equity awards generally based on the performance of Franklin Templeton Investments, its funds, and the performance of the individual employee. The USIP provides for the issuance of up to 30.0 million shares of our common stock for various stock-related awards to officers, directors and employees. At December 31, 2006, approximately 5.8 million shares were available for grant under the USIP. In addition to stock awards and stock unit awards, we may award options and other forms of stock-based compensation to officers, directors and employees under the USIP. The Compensation Committee of the Board of Directors determines the terms and conditions of awards under the AIP and USIP.

### Stock Options

The following table summarizes stock option activity:

|   |                  | Weighted-Average | Remaining  |                   |
|---|------------------|------------------|------------|-------------------|
|   | Weighted-Average | Contractual      | Aggregate  |                   |
|   | Exercise         | Term (in         | Intrinsic  |                   |
|   | Price            | Years)           | Value      |                   |
| <i>(in thousands, except weighted average exercise price)</i> | Shares           |                  |            |                   |
| Outstanding at September 30, 2006                             | 5,111            | \$ 38.04         | 4.6        | \$ 346,023        |
| Granted   |                  |                  |            |                   |
| Exercised   | (405)            | 40.60            | 4.3        |                   |
| Cancelled   | (3)              | 47.85            | 3.6        |                   |
| Forfeited/expired   |                  |                  |            |                   |
| <b>Outstanding at December 31, 2006</b>                       | <b>4,703</b>     | <b>\$ 37.82</b>  | <b>4.3</b> | <b>\$ 340,262</b> |
| <b>Exercisable at December 31, 2006</b>                       | <b>4,676</b>     | <b>\$ 37.73</b>  | <b>4.4</b> | <b>\$ 338,719</b> |

Stock option awards outstanding under the USIP generally have been granted at prices which are either equal to or above the market value of the underlying common stock on the date of grant, generally vest over three years and expire no later than ten years after the grant date. We have not granted stock option awards under the USIP since November 2004.

Effective October 1, 2005, compensation expense related to nonvested options is recognized ratably over the remaining requisite service period. At December 31, 2006, total unrecognized compensation cost related to nonvested options, which is expected to be recognized over a remaining weighted average vesting period of 0.8 years, was not material.

Our option awards are generally subject to graded vesting over a service period. We recognize compensation cost on a straight-line basis over the requisite service period for the entire award.

### Stock Awards and Stock Unit Awards

In accordance with SFAS 123R, the fair value of stock awards and stock unit awards granted under the USIP is estimated on the date of grant based on the market price of the underlying shares of common stock and is amortized to compensation expense on a straight-line basis over the related vesting period, which is generally three to four years. The total number of stock awards and stock unit awards expected to vest is adjusted for estimated forfeitures.

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Total unrecognized compensation cost related to nonvested stock awards and stock unit awards, net of estimated forfeitures, was \$96.3 million at December 31, 2006. This cost is expected to be recognized over a remaining weighted-average vesting period of 2.4 years.

The following is a summary of nonvested stock award and stock unit award activity:

| <i>(shares in thousands)</i>                  | <b>Shares</b> | <b>Fair Value</b> | <b>Weighted-Average Grant-Date</b> |
|---|---------------|-------------------|------------------------------------|
| Nonvested balance at September 30, 2006       | 697           | \$                | 75.89                              |
| Granted                                       | 720           |                   | 109.87                             |
| Vested  | (5)           |                   | 94.98                              |
| Forfeited                                     | (16)          |                   | 80.58                              |
| <b>Nonvested Balance at December 31, 2006</b> | <b>1,396</b>  | <b>\$</b>         | <b>93.03</b>                       |

Our stock awards generally entitle holders to the right to sell their shares of common stock once the awards vest. Stock unit awards generally entitle holders to receive the underlying shares of common stock once the awards vest. In addition, certain performance-based stock awards were granted to our Chief Executive Officer. The total number of shares ultimately received by the Chief Executive Officer depends on our performance against specified performance goals and is subject to vesting provisions. At December 31, 2006, the balance of nonvested shares granted to the Chief Executive Officer and subject to vesting upon the achievement of prior years' performance goals, set or determined in prior years, was 16.7 thousand and had a weighted-average grant-date fair value of \$87.11.

#### *Employee Stock Investment Plan*

The Franklin Resources, Inc. 1998 Employee Stock Investment Plan (the "ESIP") allows eligible participants to buy shares of our common stock at 90% of its market value on defined dates and, at the Company's sole discretion, to receive a 50% match of the shares purchased, provided the employee, among other conditions, has held the previously purchased shares for a defined period. The Compensation Committee and the Board of Directors determine the terms and conditions of awards under the ESIP. No shares were issued under the ESIP for the three months ended December 31, 2006. At December 31, 2006, 406.8 thousand shares were reserved for future issuance under this plan. The Board of Directors approved an amendment and restatement of the ESIP on December 13, 2006. On January 25, 2007, the stockholders of the Company also approved the amendment and restatement of the ESIP, which included an increase of 4.0 million shares authorized for issuance under the ESIP.

#### *All Stock-Based Plan Arrangements*

Total stock-based compensation costs of \$14.4 million and \$14.2 million were recognized in the Condensed Consolidated Statements of Income for the three months ended December 31, 2006 and 2005. The income tax benefits from stock-based arrangements totaled \$39.5 million and \$11.7 million for the three months ended December 31, 2006 and 2005, with approximately \$30.0 million and \$9.4 million attributed to stock option exercises for the same periods. Cash received from stock option exercises for the three months ended December 31, 2006 and 2005 was \$16.4 million and \$37.6 million. We generally do not repurchase shares upon share option exercise or vesting of stock awards and stock unit awards. However, in order to pay taxes due in connection with the vesting of employee and executive officer stock awards and stock unit awards under the USIP and in connection with matching grants under the ESIP, we repurchase shares to pay such taxes using a net stock-issuance method.

#### **Note 12 - Common Stock Repurchases**

During the three months ended December 31, 2006, we repurchased 0.7 million shares of our common stock at a cost of \$73.7 million. At December 31, 2006, approximately 8.8 million shares of our common stock remained available for repurchase under our existing stock repurchase program. During the three months ended December 31, 2005, we repurchased 0.5 million shares of our common stock at a cost of \$45.0 million. Our stock repurchase program is not subject to an expiration date.

#### **Note 13 - Segment Information**

We based our operating segment selection process primarily on services offered. We derive the majority of our revenues and net income from providing investment management, fund administration, shareholder services, transfer agency, underwriting, distribution, custodial, trustee and other fiduciary services (collectively "investment management and related services") to retail mutual funds, and to institutional, high net-worth and separately-managed accounts and other investment products, collectively called our sponsored investment products. This is our primary business activity and operating segment. Our sponsored investment products are distributed to the public globally under six distinct names: Franklin, Templeton, Mutual Series, Bissett, Fiduciary Trust, and Darby.



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Our secondary business and operating segment is banking/finance. The banking/finance operating segment offers selected retail-banking services to high net-worth clients and consumer lending services. Our consumer lending activities include automotive lending related to the purchase, securitization, and servicing of retail installment sales contracts originated by

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independent automobile dealerships, consumer credit and debit cards, real estate equity lines, and home equity/mortgage lending.

Financial information for our two operating segments is presented in the table below. Operating revenues of the banking/finance operating segment are reported net of interest expense and the provision for probable loan losses.

|  | Three Months Ended  |                     |
|--|---------------------|---------------------|
|  | December 31,        |                     |
| <i>(in thousands)</i>                      | 2006                | 2005                |
| <b>Operating Revenues</b>                  |                     |                     |
| Investment management and related services | \$ 1,412,664        | \$ 1,169,497        |
| Banking/finance                            | 15,151              | 11,955              |
| <b>Total</b>                               | <b>\$ 1,427,815</b> | <b>\$ 1,181,452</b> |
| <b>Income Before Taxes on Income</b>       |                     |                     |
| Investment management and related services | \$ 595,338          | \$ 435,997          |
| Banking/finance                            | 8,005               | 2,581               |
| <b>Total</b>                               | <b>\$ 603,343</b>   | <b>\$ 438,578</b>   |

Operating segment assets were as follows:

| <i>(in thousands)</i>                      | December 31, 2006   | September 30, 2006  |
|--|---------------------|---------------------|
| Investment management and related services | \$ 8,749,838        | \$ 8,350,966        |
| Banking/finance                            | 913,638             | 1,148,893           |
| <b>Total</b>                               | <b>\$ 9,663,476</b> | <b>\$ 9,499,859</b> |

All of our goodwill and intangible assets, as well as substantially all of our depreciation and amortization costs and expenditures on long-lived assets, relate to our investment management and related services operating segment.

Operating revenues of the banking/finance operating segment included above were as follows:

|   | Three Months Ended |                |
|---|--------------------|----------------|
|   | December 31,       |                |
| <i>(in thousands)</i>                           | 2006               | 2005           |
| Interest and fees on loans                      | \$ 5,359           | \$ 10,582      |
| Interest and dividends on investment securities | 5,272              | 3,376          |
| <b>Total interest income</b>                    | <b>10,631</b>      | <b>13,958</b>  |
| Interest on deposits                            | (3,720)            | (2,966)        |
| Interest on short-term debt                     | (1,086)            | (2,937)        |
| Interest expense inter-segment                  | (139)              | (220)          |
| <b>Total interest expense</b>                   | <b>(4,945)</b>     | <b>(6,123)</b> |
| <b>Net interest income</b>                      | <b>5,686</b>       | <b>7,835</b>   |
| <b>Other income</b>                             | <b>10,643</b>      | <b>6,137</b>   |
| <b>Provision for probable loan losses</b>       | <b>(1,178)</b>     | <b>(2,017)</b> |

|                                 |                  |                  |
|---------------------------------|------------------|------------------|
| <b>Total Operating Revenues</b> | <b>\$ 15,151</b> | <b>\$ 11,955</b> |
|---------------------------------|------------------|------------------|

Inter-segment interest payments from the banking/finance operating segment to the investment management and related services operating segment are based on market rates prevailing at the inception of each loan. Inter-segment interest income and expense are not eliminated in our Condensed Consolidated Statements of Income.

**Note 14 - Banking Regulatory Ratios**

We are a bank holding company and a financial holding company subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can result in certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse effect on our financial statements. We must meet specific capital adequacy guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain a minimum Tier 1 capital and Tier 1 leverage ratio (as defined in the regulations), as well as minimum Tier 1 and Total risk-based capital ratios (as defined in the regulations). Based on our calculations, at December 31, 2006, and September 30, 2006, we exceeded the capital adequacy requirements applicable to us as listed below.

|                                      | December 31, | September 30, | Capital<br>Adequacy |
|--------------------------------------|--------------|---------------|---------------------|
| <i>(dollar amounts in thousands)</i> | 2006         | 2006          | Minimum             |
| Tier 1 capital                       | \$5,121,905  | \$ 4,707,956  | N/A                 |
| Total risk-based capital             | 5,124,363    | 4,710,636     | N/A                 |
| Tier 1 leverage ratio                | 68%          | 66%           | 4%                  |
| Tier 1 risk-based capital ratio      | 99%          | 92%           | 4%                  |
| Total risk-based capital ratio       | 99%          | 92%           | 8%                  |

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

This Quarterly Report on Form 10-Q includes trademarks and registered trademarks of Franklin Resources, Inc. (the Company or we) and its direct and indirect subsidiaries.

**Forward-Looking Statements**

In this section, we discuss and analyze the results of operations and financial condition of Franklin Resources, Inc. (the Company or we) and its subsidiaries (collectively, Franklin Templeton Investments). In addition to historical information, we also make statements relating to the future, called forward-looking statements, which are provided under the safe harbor protection of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally written in the future tense and/or are preceded by words such as will, may, should, could, expect, believe, anticipate, intend, or other similar words. Moreover, statements that speculate about future events are forward-looking statements. These forward-looking statements involve a number of known and unknown risks, uncertainties and other important factors that could cause the actual results and outcomes to differ materially from any future results or outcomes expressed or implied by such forward-looking statements. You should carefully review the Risk Factors section set forth below and in any more recent filings with the U. S. Securities and Exchange Commission (the SEC), each of which describes these risks, uncertainties and other important factors in more detail. While forward-looking statements are our best prediction at the time that they are made, you should not rely on them. We undertake no obligation, unless required by law, to update any forward-looking statements in order to reflect events or circumstances that may arise after the date of this Quarterly Report on Form 10-Q.

**Overview**

We derive the majority of our operating revenues and net income from providing investment management, fund administration, shareholder services, transfer agency, underwriting, distribution, custodial, trustee and other fiduciary services (collectively investment management and related services) to retail mutual funds, and to institutional, high net-worth and separately-managed accounts and other investment products, collectively called our sponsored investment products. This is our primary business activity and operating segment. Our sponsored investment products are distributed to the public globally under six distinct names:

Franklin

Templeton

Mutual Series

Bissett

Fiduciary Trust

Darby

We offer a broad range of sponsored investment products under equity, hybrid, fixed-income and money market categories that meet a wide variety of specific investment needs of individual and institutional investors.

The level of our revenues depends largely on the level and relative mix of assets under management. To a lesser degree, our revenues also depend on the level of mutual fund sales and the number of mutual fund shareholder accounts. The fees charged for our services are based on contracts with our sponsored investment products or our clients. These arrangements could change in the future.

Our secondary business and operating segment is banking/finance. Our banking/finance group offers selected retail-banking services to high net-worth clients and consumer lending services. Our consumer lending activities include automotive lending related to the purchase, securitization, and servicing of retail installment sales contracts originated by independent automobile dealerships, consumer credit and debit

cards, real estate equity lines, and home equity/mortgage lending.

In the three months ended December 31, 2006, our investment management and related services operating segment continued to experience record levels of assets under management. In addition to market appreciation, which reflected, among other things, the positive performance of many equity markets globally, this growth resulted from excess sales over redemptions. In part, we attribute the continued positive trend in excess sales over redemptions to the strong relative performance of our product offerings, the successful marketing to and diversification of our client base and our focus on customer service. Consistent with the increase in our assets under management, we experienced growth in net income and higher diluted earnings per share in the three months ended December 31, 2006, as compared to the three months ended December 31, 2005.

We expect to continue to focus on our core strategies of expanding our assets under management and related operations internationally, continually seeking positive investment performance, protecting and furthering our brand recognition, developing and maintaining broker/dealer and client loyalties, providing a high level of customer service and closely monitoring costs, while also developing our human capital base and our systems and technology. The continued success of these strategies in the future is dependent on various factors, including the relative performance of our sponsored investment products, product innovations by our competitors, and changes in consumer preferences.

## RESULTS OF OPERATIONS

|  | Three Months Ended |            | Percent<br>Change |
|--|--------------------|------------|-------------------|
|  | December 31,       |            |                   |
|  | 2006               | 2005       |                   |
| <i>(dollar amounts in millions, except per share data)</i> |                    |            |                   |
| <b>Net Income</b>  | \$ 426.8           | \$ 318.0   | 34%               |
| <b>Earnings Per Common Share</b>                           |                    |            |                   |
| Basic  | \$ 1.69            | \$ 1.26    | 34%               |
| Diluted  | 1.67               | 1.21       | 38%               |
| <b>Operating Margin <sup>1</sup></b>                       | <b>36%</b>         | <b>34%</b> |                   |

<sup>1</sup> Defined as operating income divided by total operating revenues.

Net income increased by 34% and diluted earnings per share increased by 38% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year. These increases were primarily due to higher fees for providing investment management and fund administration services ( investment management fees ) and underwriting and distribution fees, consistent with an 18% increase in simple monthly average assets under management and higher gross sales on which commissions are earned. These increases were partially offset by higher underwriting and distribution expenses and higher taxes on income.

## ASSETS UNDER MANAGEMENT

|  |                   |                   | Percent<br>Change |
|--|-------------------|-------------------|-------------------|
|  | December 31, 2006 | December 31, 2005 |                   |
| <i>(in billions)</i>   |                   |                   |                   |
| <b>Equity</b>  |                   |                   |                   |
| Global/international   | \$ 240.6          | \$ 193.9          | 24%               |
| Domestic (U. S.)   | 91.0              | 79.6              | 14%               |
| Total equity   | 331.6             | 273.5             | 21%               |
| <b>Hybrid<br/>Fixed-Income</b>                                       | 98.7              | 79.7              | 24%               |
| Tax-free   | 56.6              | 53.9              | 5%                |
| Taxable  |                   |                   |                   |
| Domestic (U. S.)   | 32.4              | 32.5              | %                 |
| Global/international   | 27.3              | 19.6              | 39%               |
| Total fixed-income   | 116.3             | 106.0             | 10%               |
| <b>Money Market</b>  | 6.3               | 5.6               | 13%               |
| <b>Total</b>   | <b>\$ 552.9</b>   | <b>\$ 464.8</b>   | <b>19%</b>        |
| <b>Simple Monthly Average for the Three-Month Period<sup>2</sup></b> | <b>\$ 533.1</b>   | <b>\$ 453.3</b>   | <b>18%</b>        |

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Investment management fees from approximately 56% of our assets under management at December 31, 2006 were calculated using daily average assets under management.

Our assets under management at December 31, 2006 were \$552.9 billion, 19% higher than they were at that time in the prior fiscal year, due to excess sales over redemptions of \$16.3 billion and market appreciation of \$78.0 billion during the twelve-months ended December 31, 2006. Simple monthly average assets under management, which are generally more indicative of trends in revenue for providing investment management and fund administration services ( investment management services ) than the year over year change in ending assets under management, were 18% higher for the three months ended December 31, 2006 than for the three months ended December 31, 2005.



The simple monthly average mix of assets under management is shown below.

|              | Three Months Ended |             |
|--------------|--------------------|-------------|
|              | December 31,       |             |
|              | 2006               | 2005        |
| Equity       | 59%                | 58%         |
| Hybrid       | 18%                | 17%         |
| Fixed-income | 22%                | 23%         |
| Money market | 1%                 | 2%          |
| <b>Total</b> | <b>100%</b>        | <b>100%</b> |

For the three months ended December 31, 2006, our effective investment management fee rate (investment management fees divided by simple monthly average assets under management) increased to 0.624% from 0.607% for the same period in the prior fiscal year. The change in the mix of assets under management, resulting from higher relative excess sales over redemptions and greater appreciation of equity and hybrid products as compared to fixed-income products, and an increase in performance fees, contributed to an increase in our effective investment management fee rate. Generally, investment management fees earned on equity products are higher than fees earned on fixed-income products.

Assets under management by sales region were as follows:

|                                     | December 31,    |             | December 31,    |             |
|-------------------------------------|-----------------|-------------|-----------------|-------------|
|                                     | Percent         |             | Percent         |             |
|                                     | 2006            | of Total    | 2005            | of Total    |
| <i>(dollar amounts in billions)</i> |                 |             |                 |             |
| United States                       | \$ 387.0        | 70%         | \$ 330.5        | 71%         |
| Europe                              | 63.9            | 12%         | 49.7            | 11%         |
| Canada                              | 40.2            | 7%          | 34.9            | 7%          |
| Asia/Pacific and other <sup>3</sup> | 61.8            | 11%         | 49.7            | 11%         |
| <b>Total</b>                        | <b>\$ 552.9</b> | <b>100%</b> | <b>\$ 464.8</b> | <b>100%</b> |

<sup>3</sup> Includes multi-jurisdictional assets under management.

Components of the change in our assets under management were as follows:

|                                       | Three Months Ended |                 | Percent<br>Change |
|---------------------------------------|--------------------|-----------------|-------------------|
|                                       | December 31,       |                 |                   |
|                                       | 2006               | 2005            |                   |
| <i>(dollar amounts in billions)</i>   |                    |                 |                   |
| Beginning assets under management     | \$ 511.3           | \$ 453.1        | 13%               |
| Sales                                 | 37.6               | 30.4            | 24%               |
| Reinvested distributions              | 12.9               | 8.4             | 54%               |
| Redemptions                           | (27.6)             | (24.5)          | 13%               |
| Distributions                         | (15.6)             | (10.1)          | 54%               |
| Dispositions                          | (2.0)              |                 | N/A               |
| Appreciation                          | 36.3               | 7.5             | 384%              |
| <b>Ending Assets Under Management</b> | <b>\$ 552.9</b>    | <b>\$ 464.8</b> | <b>19%</b>        |

For the three months ended December 31, 2006, excess sales over redemptions were \$10.0 billion as compared to \$5.8 billion for the same period in the prior fiscal year. Our products experienced appreciation of \$36.3 billion for the three months ended December 31, 2006, related primarily to our equity products, as compared to market appreciation of \$7.5 billion for the same period in the prior fiscal year. Dispositions for

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the three months ended December 31, 2006 included the divestiture of assets under management of a former subsidiary at October 1, 2006.

**OPERATING REVENUES**

| <i>(dollar amounts in millions)</i>                    | <b>Three Months Ended</b> |                   | <b>Percent</b> |
|--|---------------------------|-------------------|----------------|
|  | <b>December 31,</b>       |                   | <b>Change</b>  |
|  | <b>2006</b>               | <b>2005</b>       |                |
| Investment management fees                             | \$ 831.9                  | \$ 687.4          | 21%            |
| Underwriting and distribution fees                     | 509.8                     | 414.9             | 23%            |
| Shareholder servicing fees                             | 67.6                      | 64.3              | 5%             |
| Consolidated sponsored investment products income, net | 0.8                       | 0.3               | 167%           |
| Other, net   | 17.7                      | 14.6              | 21%            |
| <b>Total Operating Revenues</b>                        | <b>\$ 1,427.8</b>         | <b>\$ 1,181.5</b> | <b>21%</b>     |

### **Investment Management Fees**

Investment management fees, accounting for 58% of our operating revenues for the three months ended December 31, 2006, and 2005 are generally calculated under contractual arrangements with our sponsored investment products as a percentage of the market value of assets under management. Annual rates vary by investment objective and type of services provided.

Investment management fees increased 21% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year, consistent with an 18% increase in simple monthly average assets under management and an increase in our effective investment management fee rate resulting from a shift in simple monthly average mix of assets from fixed-income products toward hybrid and equity products, which generally carry higher management fees than fixed-income products, and an increase in performance fees.

### **Underwriting and Distribution Fees**

We earn underwriting fees from the sale of certain classes of sponsored investment products on which investors pay a sales commission at the time of purchase. Sales commissions are reduced or eliminated on some share classes and for some sale transactions depending upon the amount invested and the type of investor. Therefore, underwriting fees will change with the overall level of gross sales, the size of individual transactions, and the relative mix of sales between different share classes and types of investors.

Globally, our mutual funds and certain other products generally pay distribution fees in return for sales, marketing and distribution efforts on their behalf. Specifically, the majority of U.S.-registered mutual funds, with the exception of certain of our money market mutual funds, have adopted distribution plans (the Plans) under Rule 12b-1 promulgated under the Investment Company Act of 1940, as amended (Rule 12b-1). The Plans permit the mutual funds to bear certain expenses relating to the distribution of their shares, such as expenses for marketing, advertising, printing and sales promotion, subject to the Plans' limitations on amounts. The individual Plans set a percentage limit for Rule 12b-1 expenses based on average daily net assets under management of the mutual fund.

Similar arrangements exist for the distribution of our global funds and where, generally, the distributor of the funds in the local market arranges for and pays commissions.

We pay a significant portion of underwriting and distribution fees to the financial advisers and other intermediaries who sell our sponsored investment products to the public on our behalf. See the description of underwriting and distribution expenses below.

Overall, underwriting and distribution fees increased 23% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year. Underwriting fees increased 24% for the three months ended December 31, 2006 over the same period in the prior fiscal year consistent with a 24% increase in gross product sales. Distribution fees increased 23% consistent with an 18% increase in simple monthly average assets under management and a shift in simple average mix of assets under management from fixed-income products to equity products. Distribution fees are generally higher for equity products, as compared to fixed-income products.

### **Shareholder Servicing Fees**

Shareholder servicing fees are generally fixed charges per shareholder account that vary with the particular type of fund and the service being rendered. In some instances, sponsored investment products are charged these fees based on the level of assets under management. We receive fees as compensation for providing transfer agency services, including providing customer statements, transaction processing, customer service and tax reporting. In the United States, transfer agency service agreements provide that accounts closed in a calendar year generally remain billable at a reduced rate through the second quarter of the following calendar year. In Canada, such agreements provide that accounts closed in the calendar year remain billable for four months after the end of the calendar year. Accordingly, the level of fees will vary with the growth in new accounts and the level of closed accounts that remain billable.

Shareholder servicing fees increased 5% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year. The increase reflects a 12% increase in simple monthly average billable shareholder accounts, partially offset by a shift to shareholder accounts that are billable at a lower rate, because of service level and regional mix of products.

**Consolidated Sponsored Investment Products Income, Net**

Consolidated sponsored investment products income, net reflects the net investment income, including dividends received, of sponsored investment products consolidated under Financial Accounting Standards Board (the FASB) FASB Statement of Financial Accounting Standards No. 94, Consolidation of All Majority-Owned Subsidiaries an amendment of ARB No. 51, with related amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12 and FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46-R).

The 167% increase for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year reflects the investment performance of the specific sponsored investment products that we consolidate.

**Other, Net**

Other, net consists primarily of revenues from our banking/finance operating segment as well as income from custody services. Revenues from the banking/finance operating segment include interest income on loans, servicing income, and investment income on banking/finance investment securities, and are reduced by interest expense and the provision for probable loan losses.

Other, net increased 21% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year primarily due to higher securitization gains, an increase in loan servicing fees and net unrealized interest-rate swap losses incurred in the comparative period in the prior fiscal year related to our automotive lending business. The increase was partly offset by a decline in interest income from automobile loans receivable.

**OPERATING EXPENSES**

|   | Three Months Ended   |                 | Percent<br>Change |
|---|----------------------|-----------------|-------------------|
|   | December 31,<br>2006 | 2005            |                   |
| <i>(dollar amounts in millions)</i>           |                      |                 |                   |
| Underwriting and distribution                 | \$ 478.0             | \$ 380.1        | 26%               |
| Compensation and benefits                     | 251.0                | 218.5           | 15%               |
| Information systems, technology and occupancy | 75.1                 | 73.9            | 2%                |
| Advertising and promotion                     | 34.9                 | 30.3            | 15%               |
| Amortization of deferred sales commissions    | 33.7                 | 32.0            | 5%                |
| Amortization of intangible assets             | 2.7                  | 4.4             | (39%)             |
| Other   | 44.3                 | 37.7            | 18%               |
| <b>Total Operating Expenses</b>               | <b>\$ 919.7</b>      | <b>\$ 776.9</b> | <b>18%</b>        |

**Underwriting and Distribution**

Underwriting and distribution includes expenses payable to financial advisers and other third parties for providing sales, marketing and distribution services to investors in our sponsored investment products. Underwriting and distribution expense increased 26% for the three months ended December 31, 2006 over the same period in the prior fiscal year consistent with similar trends in underwriting and distribution revenue.

## Compensation and Benefits

Compensation and benefits expense increased 15% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year primarily due to an increase in bonus and employee commission expense, including bonus expense under the Amended and Restated Annual Incentive Compensation Plan (the AIP), pursuant to which bonus awards have been made, based, in part, on our performance, and in relation to certain performance-based bonus plans outside of the AIP. The increase also reflected our annual merit salary adjustments that were effective December 1, 2006 and higher staffing levels. We anticipate that, for the three months ended March 31, 2007, compensation and benefits expense may be higher than during the three months ended December 31, 2006, as a result of including salaries at the adjusted level for a full quarter and an increase in payroll-related taxes.

We continue to place a high emphasis on our pay for performance philosophy. As such, any changes in the underlying performance of our sponsored investment products or changes in the composition of our incentive compensation offerings could have an impact on compensation and benefits going forward. However, in order to attract and retain talented individuals, our level of compensation and benefits may increase more quickly or decrease more slowly than our revenue. We employed approximately 8,200 people at December 31, 2006, as compared to approximately 7,300 at December 31, 2005.

## Information Systems, Technology and Occupancy

Information systems, technology and occupancy costs increased 2% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year primarily due to an increase in external data services costs and higher occupancy costs related to global expansion. This increase was partially offset by a decline in technology consulting costs that are not subject to capitalization.

Details of capitalized information systems and technology costs, which exclude occupancy costs, are shown below.

|   | Three Months Ended   |                |
|---|----------------------|----------------|
|   | December 31,<br>2006 | 2005           |
| <i>(in millions)</i>  |                      |                |
| Net carrying amount at beginning of period                      | \$ 44.9              | \$ 42.7        |
| Additions during period, net of disposals and other adjustments | 3.5                  | 5.4            |
| Amortization during period                                      | (5.7)                | (6.1)          |
| <b>Net Carrying Amount at End of Period</b>                     | <b>\$ 42.7</b>       | <b>\$ 42.0</b> |
| <b>Advertising and Promotion</b>                                |                      |                |

Advertising and promotion expense increased 15% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year due to an increase in marketing support payments made to intermediaries who sell our sponsored investment products to the public on our behalf in the United States and an increase in marketing and promotions efforts globally.

We are committed to investing in advertising and promotion in response to changing business conditions, and in order to advance our products where we see continued or potential new growth opportunities, which means that the level of advertising and promotion expenditures may increase more rapidly, or decrease more slowly, than our revenues. In addition to potential changes in our strategic marketing campaigns, advertising and promotion may also be impacted by changes in levels of sales and assets under management that affect marketing support payments made to the distributors of our sponsored investment products.

## Amortization of Deferred Sales Commissions

Certain fund share classes sold globally, including Class C and Class R shares marketed in the United States, are sold without a front-end sales charge to shareholders, although our distribution subsidiaries pay a commission on the sale. In addition, certain share classes, such as Class A shares sold in the United States, are sold without a front-end sales charge to shareholders when minimum investment criteria are met although our distribution subsidiaries pay a commission on these sales. We defer all up-front commissions paid by our distribution subsidiaries and amortize them over 12 months to 8 years depending on share class or financing arrangements.

Our U.S. funds that had offered Class B shares ceased offering these shares to new investors and existing shareholders effective during the quarter ended March 31, 2005. Existing Class B shareholders may continue to exchange shares into Class B shares of different funds. Existing Class B shareholders may also continue to reinvest dividends on Class B shares in additional Class B shares.



Historically, Class B and certain of our Class C deferred commission assets ( DCA ) arising from our U.S., Canadian and European operations have been financed through sales to or other arrangements with Lightning Finance Company Limited ( LFL ), a company in which we hold a 49% ownership interest. In December 2005, LFL transferred substantially all of its DCA to Lightning Asset Finance Limited ( LAFL ), an Irish special purpose vehicle formed in December 2005, in which we also hold a 49% ownership interest. LAFL was formed for the sole purpose of acquiring and holding substantially all of the DCA owned by LFL as of December 29, 2005. The holder of the 51% ownership interests in both LFL and LAFL is a subsidiary of an international banking institution which is not affiliated with Franklin Templeton Investments. As our U.S. distribution subsidiary, Franklin/Templeton Distributors, Inc. ( FTDI ), entered into a financing arrangement with LFL, we maintain a continuing interest in the DCA transferred to it. As a result, we retain the DCA originally sold under the U.S. agreement in our Consolidated Financial Statements and amortize them over an 8-year period, or until sold by LAFL. Neither we nor our distribution subsidiaries retain any direct ownership interest in the DCA sold, and, therefore, the sold DCA are not available to satisfy claims of our creditors or those of our distribution subsidiaries. In contrast to the U.S. arrangements, the arrangements outside the United States are, in most cases, direct agreements with our Canadian and European sponsored investment products, and, as a result, we do not record DCA from these sources in our Consolidated Financial Statements. As of December 2005, our DCA have been financed generally by an independent third party.

Amortization of deferred sales commissions increased 5% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year reflecting an increase in sales of fund shares sold without front-end sales charges.

#### **Amortization of Intangible Assets and Intangible Assets Impairment**

Amortization of intangible assets decreased 39% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year, reflecting the lower net carrying value of definite-lived intangible assets following a \$68.4 million non-cash impairment charge, recorded in the quarter ended March 31, 2006, related to certain intangible assets of Fiduciary Trust Company International ( Fiduciary Trust ), as explained below.

During the three months ended March 31, 2006, Fiduciary Trust, a subsidiary of the Company, implemented a plan of reorganization designed to emphasize its distinct high net-worth brand and to pursue further integration opportunities with Franklin Templeton Investments for its institutional business line. These changes to Fiduciary Trust's business required us to review the carrying value of acquired customer base intangible assets of Fiduciary Trust. As a result of these changes, we recorded a \$68.4 million non-cash impairment charge to the customer base definite-lived intangible assets of Fiduciary Trust in the three months ended March 31, 2006.

During the quarter ended December 31, 2006, we completed our most recent annual impairment testing of goodwill and indefinite-lived intangible assets under the guidance set out in FASB Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ), and we determined that there was no impairment to these assets as of October 1, 2006.

#### **Other Operating Expenses**

Other operating expenses consist primarily of professional fees, investment management and shareholder servicing fees payable to external parties, corporate travel and entertainment, and other miscellaneous expenses.

Other operating expenses increased 18% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year due primarily to higher investment management fees payable to external parties and higher consulting and professional fees, including additional costs related to the distribution of market-timing settlements.

#### **OTHER INCOME (EXPENSES)**

Other income (expenses) includes net realized and unrealized investment gains (losses) of consolidated sponsored investment products, investment and other income, net and interest expense. Investment and other income, net is comprised primarily of income related to our investments, including dividends, interest income, realized gains and losses and income from investments accounted for using the equity method of accounting, as well as minority interest in less than wholly-owned subsidiaries and sponsored investment products that we consolidate and foreign currency exchange gains and losses.

Other income (expenses) increased 180% for the three months ended December 31, 2006, as compared to the same period in the prior fiscal year primarily due to higher realized and unrealized net gains from our consolidated sponsored investment products, net of minority interest and higher equity-method income from unconsolidated affiliates, interest income, dividends and realized gains from our investments. In addition, in the three months ended December 31, 2005, we recorded an other-than-temporary decline in certain of our long-term investments.





Details of Other Income (Expenses) are shown below.

| <i>(in thousands)</i>                                 | Three Months Ended   |                  |
|---|----------------------|------------------|
|   | December 31,<br>2006 | 2005             |
| Consolidated sponsored investment products gains, net | \$ 30,286            | \$ 10,814        |
| Investment and other income, net                      |                      |                  |
| Dividends   | 18,121               | 12,589           |
| Interest income                                       | 33,390               | 22,784           |
| Other income (expenses), net                          | 19,598               | (3,007)          |
| <b>Total</b>  | <b>71,109</b>        | <b>32,366</b>    |
| Interest expense                                      | (6,122)              | (9,188)          |
| <b>Other Income, Net</b>                              | <b>\$ 95,273</b>     | <b>\$ 33,992</b> |

### Taxes on Income

As a multi-national corporation, we provide investment management and related services to a wide range of international sponsored investment products, often managed from locations outside the United States. Some of these jurisdictions have lower tax rates than the United States. The mix of pre-tax income (primarily from our investment management and related services business) subject to these lower rates, when aggregated with income originating in the United States, produces a lower overall effective income tax rate than existing U.S. federal and state income tax rates.

Our effective income tax rate for the three months ended December 31, 2006 was 29.26% and has increased from 27.50% for the comparative period in the prior fiscal year due to, in part, to the mix of pre-tax income as well as a change in income taxes recorded in relation to certain non-recurring items. The effective income tax rate for future reporting periods will continue to reflect the relative contributions of foreign earnings that are subject to reduced tax rates and that are not currently included in U.S. taxable income, as well as other factors, including a reduction in our tax liabilities due to a favorable U.S. state tax ruling and certain international tax rulings obtained in prior years, which are in effect through fiscal year 2007.

### LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes certain key financial data relating to our liquidity, and sources and uses of capital.

| <i>(in millions)</i>      | December 31, 2006 | September 30, 2006 |
|---------------------------|-------------------|--------------------|
| <b>Balance Sheet Data</b> |                   |                    |
| <b>Assets</b>             |                   |                    |
| Liquid assets             | \$ 5,835.7        | \$ 5,347.8         |
| Cash and cash equivalents | 4,006.0           | 3,613.1            |
| <b>Liabilities</b>        |                   |                    |
| <b>Debt</b>               |                   |                    |
| Federal funds purchased   | \$ 3.0            | \$                 |
| Variable Funding Notes    | 118.6             | 232.3              |
| Commercial paper          | 168.1             | 168.1              |
| Medium Term Notes         | 420.0             | 420.0              |
| Other long-term debt      | 193.0             | 207.9              |
| <b>Total Debt</b>         | <b>\$ 902.7</b>   | <b>\$ 1,028.3</b>  |

Three Months Ended December 31,

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| <i>(in millions)</i>  | 2006     | 2005     |
|-----------------------|----------|----------|
| <b>Cash Flow Data</b> |          |          |
| Operating cash flows  | \$ 551.3 | \$ 546.6 |
| Investing cash flows  | 23.4     | 147.7    |
| Financing cash flows  | (181.7)  | (220.1)  |
| <i>Liquidity</i>      |          |          |

Liquid assets, which consist of cash and cash equivalents, investment securities (trading and available-for-sale) and current receivables, increased from September 30, 2006, primarily due to cash provided by operating activities. Cash and cash equivalents include cash, debt instruments with maturities of three months or less at the purchase date and other highly liquid investments that are readily convertible into cash, including money market funds. Cash and cash equivalents increased from

September 30, 2005 as we invested operating cash flows in debt instruments, including U.S. T-bills, term and other interest-bearing deposits, with maturities of three months or less from the purchase date.

The decrease in total debt outstanding from September 30, 2006 relates primarily to repayments made under a one-year revolving \$250.0 million variable funding note warehouse credit facility, subsequent to the completion of an automobile loan securitization transaction in October 2006.

Operating cash flows for the three months ended December 31, 2006 were consistent with operating cash flows for the three months ended December 31, 2005, although we experienced higher net income and a lower decline in the provision for governmental investigations, proceedings and actions, net, partly offset by higher originations of loans held for sale, and an increase in receivables, prepaid expenses and other. Our investing activities provided lower net cash flows in the three months ended December 31, 2006, as compared to the three months ended December 31, 2005, due primarily to lower net liquidations of investments. The decrease in cash used in financing activities, as compared to the three months ended December 31, 2005, included an increase in debt, partly offset by a decrease in bank deposits and an increase in purchases of our common stock.

During the three months ended December 31, 2006, we repurchased 0.7 million shares of our common stock at a cost of \$73.7 million. At December 31, 2006, approximately 8.8 million shares remained available for repurchase under our existing stock repurchase program. During the three months ended December 31, 2005, we repurchased 0.5 million shares of our common stock at a cost of \$45.0 million. Our stock repurchase program is not subject to an expiration date.

#### *Capital Resources*

We believe that we can meet our present and reasonably foreseeable operating cash needs and future commitments through existing liquid assets, continuing cash flows from operations, borrowing capacity under current credit facilities and the ability to issue debt or equity securities. In particular, we expect to finance future investment in our banking/finance activities through operating cash flows, debt, increased deposit base, and through the securitization of a portion of the receivables from consumer lending activities.

As of December 31, 2006, we had \$420.0 million available under a Five Year Facility Credit Agreement with certain banks and financial institutions expiring in the fiscal year ending September 30, 2010, \$300.0 million of debt and equity securities available to be issued under a shelf registration statement filed with the SEC and \$330.0 million of commercial paper available for issuance under a \$500 million private placement. In addition, at December 31, 2006, our banking/finance operating segment had \$462.0 million in available uncommitted short-term bank lines under the Federal Reserve Funds system, the Federal Reserve Bank discount window, and Federal Home Loan Bank short-term borrowing capacity.

Our ability to access the capital markets in a timely manner depends on a number of factors including our credit rating, the condition of the global economy, investors' willingness to purchase our securities, interest rates, credit spreads and the valuation levels of equity markets. In extreme circumstances, we might not be able to access this liquidity readily.

Our investment management and related services operating segment has historically financed Class B and certain Class C DCA arising from our U.S., Canadian and European operations through sales to or other arrangements with LFL, a company in which we hold a 49% ownership interest. As noted above, in December 2005, LFL transferred substantially all of its DCA to LAFL, an Irish special purpose vehicle formed in December 2005, in which we also hold a 49% ownership interest. Subsequent to the transfer of DCA to LAFL, DCA originating from our non-U.S. operations have been financed generally by an independent third party. As also noted above, the U.S. funds that had offered Class B shares ceased offering these shares to new investors and existing shareholders effective during the quarter ended March 31, 2005. Class B and C share sales commissions that we have financed globally through LFL during the three months ended December 31, 2005 were approximately \$17.7 million. LAFL's ability to access the securitization market in the future, will directly affect our existing financing arrangements.

Our banking/finance operating segment finances its automotive lending activities through operational cash flows, the issuance of notes under a one-year revolving \$250.0 million variable funding note warehouse credit facility, inter-segment loans and by selling its automobile loans in securitization transactions with qualified special purpose entities, which then issue asset-backed securities to private investors. Gross sale proceeds from automobile loan securitization transactions were \$353.5 million for the three months ended December 31, 2006 and \$348.3 million for the three months ended December 31, 2005.

The banking/finance segment finances its automotive lending business primarily by issuing variable funding notes (the Variable Funding Notes) under a one-year revolving \$250.0 million variable funding note warehouse credit facility, originally entered into in March 2005, and subsequently extended for an additional one-year term in March 2006. The Variable Funding Notes are payable to certain administered conduits and are secured by cash and a pool of automobile loans that meet or are expected to meet certain eligibility requirements. Credit enhancements for the Variable Funding Notes



require us to provide, as collateral, loans held for sale with a fair value in excess of the principal amount of the Variable Funding Notes, as well as to hold in trust additional cash balances to cover certain shortfalls. In addition, we provide a payment provider commitment in an amount not to exceed 4.66% of the pool balance. We also enter into interest-rate swap agreements intended to mitigate the interest-rate risk between the fixed interest rate on the pool of automobile loans and the floating interest rate being paid on the Variable Funding Notes accounted for as freestanding derivatives. We expect to extend or replace the variable funding warehouse credit facility upon the expiration of the current facility.

Our ability to access the securitization and capital markets will directly affect our plans to finance the automobile loan portfolio in the future.

#### *Uses of Capital*

We expect that the main uses of cash will be to expand our core business, make strategic acquisitions, acquire shares of our common stock, fund property and equipment purchases, pay operating expenses of the business, enhance technology infrastructure and business processes, pay stockholder dividends and repay and service debt.

On December 13, 2006, our Board of Directors declared a regular quarterly cash dividend of \$0.15 per share payable on January 12, 2007 to stockholders of record on December 28, 2006.

We continue to look for opportunities to control our costs and expand our global presence. In this regard, in fiscal year 2005 we entered into a commitment to acquire land and build a campus in Hyderabad, India, to establish support services for several of our global functions. Our estimated total cost to complete the campus at December 31, 2006 was \$43.9 million, of which \$26.5 million had been incurred as of this date. We inaugurated the opening of the campus in January 2007.

In November 2006, we announced that Franklin Templeton Investments agreed in principle to acquire full ownership of its joint venture in India, Franklin Templeton Asset Management (India) Private Limited ( AMC ), subject to regulatory approvals and to execution of a formal agreement. Franklin Templeton Investments will purchase the 25% stake in AMC 's total equity paid-up capital held by Hathaway Investments, a member of the Rajan Raheja Group.

#### **CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS**

Our contractual obligations are summarized in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006. As of December 31, 2006, there had been no material changes outside the ordinary course in our contractual obligations from September 30, 2006.

In relation to the automobile loan securitization transactions that we have entered into with a number of qualified special purpose entities, we are obligated to cover shortfalls in amounts due to the holders of the notes up to certain levels as specified under the related agreements. As of December 31, 2006, the maximum potential amount of future payments related to these obligations was \$34.9 million and the fair value of obligations arising from automobile securitization transactions entered into subsequent to December 31, 2002 reflected on our Condensed Consolidated Balance Sheet at December 31, 2006 was not significant.

At December 31, 2006, the banking/finance operating segment had commitments to extend credit aggregating \$217.5 million, primarily under its credit card lines, and had issued financial standby letters of credit totaling \$1.3 million on which beneficiaries would be able to draw upon in the event of non-performance by our customers, primarily in relation to lease and lien obligations of these banking customers. These standby letters of credit were secured by marketable securities with a fair value of \$2.4 million as of December 31, 2006.

#### **OFF-BALANCE SHEET ARRANGEMENTS**

As discussed above, we hold a 49% ownership interest in LFL and LAFL and we account for the ownership interest in these companies using the equity method of accounting. As of December 31, 2006, LFL had approximately \$16.7 million in total assets and our exposure to loss related to LFL was limited to the carrying value of our investment, and interest and fees receivable totaling approximately \$1.0 million. As of December 31, 2006, LAFL had approximately \$427.2 million in total assets and our maximum exposure to loss related to LAFL totaled approximately \$210.5 million. We recognized pre-tax loss of approximately \$0.3 million and \$0.8 million for our share of LFL 's and LAFL 's net losses for the quarter ended December 31, 2006 and 2005. Due to our significant interest in both LFL and LAFL, we continue to carry on our balance sheet the DCA originally sold to LFL by FTDI until these assets are amortized or sold by LAFL. Neither we nor our distribution subsidiaries retain any direct ownership interest in either the DCA sold, and therefore, the sold DCA are not available to satisfy claims of our creditors or those of our distribution subsidiaries.

As discussed above, our banking/finance operating segment periodically enters into automobile loan securitization transactions with qualified special purpose entities, which then issue asset-backed securities to private investors. Our main objective in entering into securitization transactions is to obtain financing for automobile loan activities. Securitized loans held by the securitization trusts totaled \$751.4 million at December 31, 2006 and \$514.8 million at September 30, 2006.

## CRITICAL ACCOUNTING POLICIES

Our financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make estimates and assumptions that impact our financial position and results of operations. These estimates and assumptions are affected by our application of accounting policies. Below we describe certain critical accounting policies that we believe are important to understanding our results of operations and financial position. For additional information about our accounting policies, please refer to Note 1 to the financial statements contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

### *Goodwill and Other Intangible Assets*

We make significant estimates and assumptions when valuing goodwill and other intangible assets in connection with the initial purchase price allocation of an acquired entity, as well as when evaluating impairment of intangibles on an ongoing basis.

Under SFAS 142, we are required to test the fair value of goodwill and indefinite-lived intangibles when there is an indication of impairment, or at least once a year. Goodwill impairment is indicated when the carrying amount of a reporting unit exceeds its implied fair value, calculated based on anticipated discounted cash flows. In estimating the fair value of the reporting unit, we use valuation techniques based on discounted cash flows similar to models employed in analyzing the purchase price of an acquisition target.

Intangible assets subject to amortization are reviewed for impairment on the basis of the expected future undiscounted operating cash flows, without interest charges, to be derived from these assets. We review definite-lived intangible assets for impairment when there is an indication of impairment, or at least once a year.

During the quarter ended December 31, 2006, we completed our annual impairment testing of goodwill and indefinite-lived intangible assets under the guidance set out in SFAS 142 and we determined that there was no impairment in the value of these assets as of October 1, 2006.

In performing our analysis, we used certain assumptions and estimates, including those related to discount rates and the expected future period of cash flows to be derived from the assets, based on, among other factors, historical trends and the characteristics of the assets. While we believe that our testing was appropriate, if these estimates and assumptions change in the future, we may be required to record impairment charges or otherwise increase amortization expense.

### *Income Taxes*

As a multinational corporation, we operate in various locations outside the United States and generate earnings from our foreign subsidiaries. At December 31, 2006, and based on tax laws in effect as of this date, it is our intention to continue to indefinitely reinvest the undistributed earnings of foreign subsidiaries. As a result, we have not made a provision for U.S. taxes and have not recorded a deferred tax liability on \$1.8 billion of cumulative undistributed earnings recorded by foreign subsidiaries at December 31, 2006. Changes to our policy of reinvesting foreign earnings may have a significant effect on our financial condition and results of operations.

### *Valuation of Investments*

We record substantially all investments in our financial statements at fair value or amounts that approximate fair value. Where available, we use prices from independent sources such as listed market prices or broker or dealer price quotations. For investments in illiquid and privately held securities that do not have readily determinable fair values, we estimate the value of the securities based upon available information. However, even where the value of a security is derived from an independent market price or broker or dealer quote, some assumptions may be required to determine the fair value. For example, we generally assume that the size of positions in securities that we hold would not be large enough to affect the quoted price of the securities when sold, and that any such sale would happen in an orderly manner. However, these assumptions may be incorrect and the actual value realized on sale could differ from the current carrying value.

We evaluate our investments for other-than-temporary decline in value on a periodic basis. This may exist when the fair value of an investment security has been below the carrying value for an extended period of time. As most of our investments are carried at fair value, if an other-than-temporary decline in value is determined to exist, the unrealized investment loss recorded net of tax in accumulated other comprehensive income is realized as a charge to net income, in the period in which the other-than-temporary decline in value is determined. We

classify securities as trading when it is management's intent at

the time of purchase to sell the security within a short period of time. Accordingly, we record unrealized gains and losses on these securities in our consolidated income.

While we believe that we have accurately estimated the amount of other-than-temporary decline in value in our portfolio, different assumptions could result in changes to the recorded amounts in our financial statements.

#### *Loss Contingencies*

We are involved in various lawsuits and claims encountered in the normal course of business. When such a matter arises and periodically thereafter, we consult with our legal counsel and evaluate the merits of the claims based on the facts available at that time. In management's opinion, an adequate accrual has been made as of December 31, 2006 to provide for any probable losses that may arise from these matters for which we could reasonably estimate an amount. See also Note 10 to our Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this report.

#### *Variable Interest Entities*

Under FIN 46-R, a variable interest entity ( VIE ) is an entity in which the equity investment holders have not contributed sufficient capital to finance its activities or the equity investment holders do not have defined rights and obligations normally associated with an equity investment. FIN 46-R requires consolidation of a VIE by the enterprise that has the majority of the risks and rewards of ownership, referred to as the primary beneficiary.

Evaluating whether related entities are VIEs, and determining if we qualify as the primary beneficiary of these VIEs, is highly complex and involves the use of estimates and assumptions. To determine our interest in the expected losses or residual returns of each VIE, we performed an expected cash flow analysis using certain discount rate and volatility assumptions based on available historical information and management's estimates. While we believe that our testing and approach were appropriate, future changes in estimates and assumptions may affect our decision and lead to the consolidation of other VIEs in our financial statements.

### **RISK FACTORS**

*We are subject to extensive and often complex, overlapping and frequently changing regulation domestically and abroad.* Our investment management and related services business and our banking/finance business are subject to extensive and often complex, overlapping and frequently changing regulation in the United States and abroad, including, among others, securities, banking, accounting and tax laws and regulations. Moreover, financial reporting requirements, and the processes, controls and procedures that have been put in place to address them, are often comprehensive and complex. While management has focused attention and resources on our compliance policies, procedures and practices, non-compliance with applicable laws or rules or regulations, conflicts of interest requirements or fiduciary principles, either in the United States or abroad, or our inability to keep up with, or adapt to, an often ever changing, complex regulatory environment could result in sanctions against us, including fines and censures, injunctive relief, suspension or expulsion from a particular jurisdiction or market or the revocation of licenses, any of which could also adversely affect our reputation, prospects, revenues, and earnings.

We are subject to federal securities laws, state laws regarding securities fraud, other federal and state laws and rules and regulations of certain regulatory and self regulatory organizations, including those rules and regulations promulgated by, among others, the SEC, the National Association of Securities Dealers (the NASD ) and the NYSE, and to the extent operations or trading in our securities take place outside the United States, by foreign regulations and regulators, such as the U.K. Listing Authority. Certain of our subsidiaries are registered with the SEC under the Investment Advisers Act of 1940, as amended, and many of our funds are registered with the SEC under the Investment Company Act of 1940, as amended, both of which impose numerous obligations, as well as detailed operational requirements, on our subsidiaries which are investment advisers to registered investment companies. Our subsidiaries, both in the United States and abroad, must comply with a myriad of complex and often changing U.S. and/or foreign regulations, some of which may conflict, including complex U.S. and non-U.S. tax regimes. Additionally, as we expand our operations, sometimes rapidly, into non-U.S. jurisdictions, the rules and regulations of these non-U.S. jurisdictions become applicable, sometimes with short compliance deadlines, and add further regulatory complexity to our ongoing compliance operations.

In addition, we are a bank holding company and a financial holding company subject to the supervision and regulation of the Federal Reserve Board, or FRB, and are subject to the restrictions, limitations, or prohibitions of the Bank Holding Company Act of 1956, as amended, and the Gramm-Leach-Bliley Act. The FRB may impose additional limitations or restrictions on our activities, including if the FRB believes that we do not have the appropriate financial and managerial resources to commence or conduct an activity or make an acquisition. Further, our subsidiary, Fiduciary Trust, is subject to extensive regulation, supervision and examination by the Federal Deposit Insurance Corporation (the FDIC ) and New York State Banking Department, while other subsidiaries are subject to oversight by the Office of Thrift Supervision and various state regulators. The laws and regulations imposed by these regulators generally involve restrictions and requirements in





connection with a variety of technical, specialized and recently expanding matters and concerns. For example, compliance with anti-money laundering and Know-Your-Customer requirements, both domestically and internationally, and the Bank Secrecy Act has taken on heightened importance with regulators as a result of efforts to, among other things, limit terrorism. At the same time, there has been increased regulation with respect to the protection of customer privacy and the need to secure sensitive customer information. As we continue to address these requirements or focus on meeting new or expanded ones, we may expend a substantial amount of time and resources, even though our banking/finance business does not constitute our dominant business sector. Moreover, any inability to meet these requirements, within the timeframes set by regulators, may subject us to sanctions or other restrictions by the regulators that impact our broader business.

*Regulatory and legislative actions and reforms are making the regulatory environment in which we operate more costly and future actions and reforms could adversely impact our assets under management, increase costs and negatively impact our profitability and future financial results.* Since 2001, the federal securities laws have been augmented substantially and made significantly more complex by, among other measures, the Sarbanes-Oxley Act of 2002 and the USA Patriot Act of 2001. Moreover, changes in the interpretation or enforcement of existing laws or regulations have directly affected our business. With new laws and changes in interpretation and enforcement of existing requirements, the associated time we must dedicate to, and related costs we must incur in, meeting the regulatory complexities of our business have increased. These outlays have also increased as we expand our business into various non-U.S. jurisdictions. For example, in the past few years following the enactment of the Sarbanes-Oxley Act of 2002, new rules of the SEC, NYSE and NASD were promulgated and other rules revised. Among other things, these new requirements have necessitated us to make changes to our corporate governance and public disclosure policies, procedures and practices and our registered investment companies and investment advisers have been required to make similar changes. In addition, complex accounting and financial reporting requirements have been implemented in the past several years pursuant to the Sarbanes-Oxley Act of 2002 and the rules of the SEC and the Public Company Accounting Oversight Board, which apply across differing legal entities within our corporate structure and varied geographical and/or jurisdictional areas in which we operate. Compliance activities to meet these new requirements have required us to expend additional time and resources, including without limitation substantial efforts to conduct evaluations required to ensure compliance with the management certification and attestation requirements under the Sarbanes-Oxley Act of 2002, and, consequently, we are incurring increased costs of doing business, which potentially negatively impacts our profitability and future financial results. Moreover, any potential accounting or reporting error, whether financial or otherwise, if material, could damage our reputation; adversely affect our ability to conduct business, and decrease revenue and net income. Finally, any regulatory and legislative actions and reforms affecting the mutual fund industry, including compliance initiatives, may negatively impact revenues by increasing our costs of accessing or dealing in the financial markets.

*Our ability to maintain the beneficial tax treatment we anticipate with respect to foreign earnings we have repatriated is based on current interpretations of the Jobs Act and timely and permitted use of such amounts in accordance with our domestic reinvestment plan and the Jobs Act.* In September 2006, we completed our planned repatriation into the United States of approximately \$2.1 billion of undistributed earnings of our non-U.S. subsidiaries in accordance with our domestic reinvestment plan and the American Jobs Creation Act of 2004 (the Jobs Act). However, our ability to maintain the anticipated beneficial tax treatment with respect to these foreign earnings is subject to current interpretations and compliance with the Jobs Act (including Internal Revenue Code Section 965), as well as the rules and regulations promulgated by, among others, the Internal Revenue Service and the United States Treasury Department. Moreover, changes in the interpretation of these rules and regulations may have an effect on our ability to maintain the beneficial tax treatment with respect to our repatriated foreign earnings. Our inability to timely complete, to appropriately use repatriated amounts for permitted purposes or to otherwise satisfy the requirements of our planned repatriation could also have a negative impact on the scope and breadth of our anticipated tax treatment with respect to such amounts.

*Any significant limitation or failure of our software applications and other technology systems that are critical to our operations could constrain our operations.* We are highly dependent upon the use of various proprietary and third-party software applications and other technology systems to operate our business. We use our technology to, among other things, obtain securities pricing information, process client transactions and provide reports and other customer services to the clients of the funds we manage. Any inaccuracies, delays or systems failures in these and other processes could subject us to client dissatisfaction and losses. Although we take protective measures, including measures to effectively secure information through system security technology, our technology systems may still be vulnerable to unauthorized access, computer viruses or other events that have a security impact, such as an authorized employee or vendor inadvertently causing us to release confidential information, which could materially damage our operations or cause the disclosure or modification of sensitive or confidential information. Moreover, loss of confidential customer identification information could harm our reputation. Further, although we take precautions to password protect our laptops and other mobile electronic hardware, if such hardware is stolen, misplaced or left unattended, it may become vulnerable to hacking or other unauthorized use, creating a possible security risk and resulting in potentially costly actions by us. Most of the software applications that we use in our business are

licensed from, and supported, upgraded and maintained by, third-party vendors. A suspension or termination of certain of these licenses or the related support, upgrades and maintenance could cause temporary system delays or interruption. In addition, we have outsourced to a single vendor the operation of our U.S. data centers, which includes responsibility for processing data and managing the centers. This vendor is also responsible for our disaster recovery systems. A failure by this vendor to continue to manage our U.S. data centers and our disaster recovery systems adequately in the future could have a material adverse impact on our business. Moreover, although we have in place certain disaster recovery plans, we may experience system delays and interruptions as a result of natural disasters, power failures, acts of war, and third party failures. Technology is subject to rapid change and we cannot guarantee that our competitors may not implement more advanced Internet platforms for their products which could affect our business. Potential system failures or breaches, or advancements in technology, and the cost necessary to address them, could result in material financial loss or costs, regulatory actions, breach of client contracts, reputational harm or legal claims and liability, which in turn could negatively impact our revenues and income.

*We face risks, and corresponding potential costs and expenses, associated with conducting operations and growing our business in numerous foreign countries.* We sell mutual funds and offer investment management and related services in many different regulatory jurisdictions around the world, and intend to continue to expand our operations internationally. As we do so, we will continue to face various ongoing challenges to ensure that we have sufficient resources, procedures and controls in place to address and ensure that our operations abroad operate consistently and effectively. In order to remain competitive, we must be proactive and prepared to implement necessary resources when growth opportunities present themselves, whether as a result of a business acquisition or rapidly increasing business activities in particular markets or regions. As we grow, we face a heightened risk that the necessary resources and/ or personnel will be unavailable to take full advantage of strategic opportunities when they appear or that strategic decisions can be efficiently implemented. Local regulatory environments may vary widely, as may the adequacy and sophistication of each. Similarly, local distributors, and their policies and practices as well as financial viability, may be inconsistent or less developed or mature. Notwithstanding potential long-term cost savings by increasing certain operations, such as transfer agent and other back-office operations, in countries or regions of the world with lower operating costs, growth of our international operations may involve near-term increases in expenses as well as additional capital costs, such as information, systems and technology costs and costs related to compliance with particular regulatory or other local requirements or needs. Local requirements or needs may also place additional demands on sales and compliance personnel and resources, such as meeting local language requirements while also integrating personnel into an organization with a single operating language. Finding and hiring additional, well-qualified personnel and crafting and adopting policies, procedures and controls to address local or regional requirements remain a challenge as we expand our operations internationally. Moreover, regulators in non-U.S. jurisdictions could also change their policies or laws in a manner that might restrict or otherwise impede our ability to distribute or register investment products in their respective markets. Any of these local requirements, activities or needs could increase the costs and expenses we incur in a specific jurisdiction without any corresponding increase in revenues and income from operating in the jurisdiction. In addition, from time to time we enter into foreign-based joint ventures in which we may not have legal control. These investments in joint ventures may involve risks, including the risk that the controlling joint venture partner may have business interests, strategies or goals that are inconsistent with ours, and the risk that business decisions or other actions or omissions of the controlling joint venture partner or the joint venture company may result in harm to our reputation or adversely affect the value of our investment in the joint venture.

*We depend on key personnel and our financial performance could be negatively affected by the loss of their services.* The success of our business will continue to depend upon our key personnel, including our portfolio and fund managers, investment analysts, investment advisers, sales and management personnel and other professionals as well as our executive officers and business unit heads. In a tightening labor market, competition for qualified, motivated and highly skilled executives, professionals and other key personnel in the asset management and banking/finance industries remains significant. Our success depends to a substantial degree upon our ability to attract, retain and motivate qualified individuals, including through competitive compensation packages, and upon the continued contributions of these people. As our business grows, we are likely to need to increase correspondingly the overall number of individuals that we employ. Moreover, in order to retain certain key personnel, we may be required to increase compensation to such individuals, resulting in additional expense without a corresponding increase in potential revenue. We cannot assure you that we will be successful in attracting and retaining qualified individuals, and the departure of key investment personnel, in particular, if not replaced, could cause us to lose clients, which could have a material adverse effect on our financial condition, results of operations and business prospects.

*Strong competition from numerous and sometimes larger companies with competing offerings and products could limit or reduce sales of our products, potentially resulting in a decline in our market share, revenues and net income.* We compete with numerous asset management companies, mutual fund, stock brokerage and investment banking firms, insurance companies, banks, savings and loan associations and other financial institutions. Our investment products also compete with products offered by these competitors as well as real estate investment trusts, hedge funds and others. Over the past decade, a significant number of new asset management firms and mutual funds have been established, increasing competition. At the same time, consolidation in the financial services industry has created stronger competitors with greater financial resources and broader distribution channels than our own. Competition is based on various factors, including, among others, business

reputation, investment performance, product offerings, service quality, distribution relationships, and fees charged. Additionally, competing securities broker/dealers whom we rely upon to distribute and sell our mutual funds may also sell their own proprietary funds and investment products, which could limit the distribution of our investment products. To the extent that existing or potential customers, including securities broker/dealers, decide to invest in or distribute the products of our competitors, the sales of our products as well as our market share, revenues and net income could decline. Our ability to attract and retain assets under our management is also dependent on the relative investment performance of our funds and other managed investment portfolios, offering a mix of sponsored investment products that meets investor demand and our ability to maintain our investment management services fees at competitive levels.

*Changes in the distribution channels on which we depend could reduce our revenues and hinder our growth.* We derive nearly all of our fund sales through broker/dealers and other similar investment advisers. Increasing competition for these distribution channels and recent regulatory initiatives have caused our distribution costs to rise and could cause further increases in the future or could otherwise negatively impact the distribution of our products. Higher distribution costs lower our net revenues and earnings. Additionally, if one or more of the major financial advisers who distribute our products were to cease operations or limit or otherwise end the distribution of our products, it could have a significant adverse impact on our revenues and earnings. There is no assurance we will continue to have access to the third-party broker/dealers and similar investment advisers that currently distribute our products, or continue to have the opportunity to offer all or some of our existing products through them. A failure to maintain strong business relationships with the major investment advisers who currently distribute our products may also impair our distribution and sales operations. Because we use broker/dealers and other similar investment advisers to sell our products, we do not control the ultimate investment recommendations given to clients. Any inability to access and successfully sell our products to clients through third-party distribution channels could have a negative effect on our level of assets under management, related revenues and overall business and financial condition.

*The amount or mix of our assets under management are subject to significant fluctuations and could negatively impact our revenues and income.* We have become subject to an increased risk of asset volatility from changes in the domestic and global financial and equity markets. Individual financial and equity markets may be adversely affected by political, financial or other instabilities that are particular to the country or regions in which a market is located, including without limitation local acts of terrorism, economic crises or other business, social or political crises. Declines in these markets have caused in the past, and would cause in the future, a decline in our revenues and income. Global economic conditions, exacerbated by war or terrorism or financial crises, changes in the equity market place, currency exchange rates, interest rates, inflation rates, the yield curve and other factors that are difficult to predict affect the mix, market values and levels of our assets under management. Our investment management services revenues are derived primarily from fees based on a percentage of the value of assets under management and vary with the nature of the account or product managed. A decline in the price of stocks or bonds, or in particular market segments, or in the securities market generally, could cause the value and returns on our assets under management to decline, resulting in a decline in our revenues and income. Moreover, changing market conditions may cause a shift in our asset mix between international and U.S. assets, potentially resulting in a decline in our revenue and income depending upon the nature of our assets under management and the level of management fees we earn based on them. Additionally, changing market conditions may cause a shift in our asset mix towards fixed-income products and a related decline in our revenue and income, as we generally derive higher fee revenues and income from equity assets than from fixed-income products we manage. On the other hand, increases in interest rates, in particular if rapid, or high interest rates, as well as any uncertainty in the future direction of interest rates, may have a negative impact on our fixed-income products as rising interest rates or interest rate uncertainty typically decrease the total return on many bond investments due to lower market valuations of existing bonds. Any decrease in the level of assets under management resulting from price declines, interest rate volatility or uncertainty or other factors could negatively impact our revenues and income.

*Our increasing focus on international markets as a source of investments and sales of investment products subjects us to increased exchange rate and other risks in connection with earnings and income generated overseas.* While we operate primarily in the United States, we also provide services and earn revenues in The Bahamas, Canada, Europe, Asia, South America, Africa, Australia and Mexico. As a result, we are subject to foreign exchange risk through our foreign operations. While we have taken steps to reduce our exposure to foreign exchange risk, for example, by denominating a significant amount of our transactions in U.S. dollars, the situation may change in the future as our business continues to grow outside the United States. Stabilization or appreciation of the U.S. dollar could moderate revenues from sales of investment products internationally or could affect relative investment performance of certain funds invested in non-U.S. securities. Separately, management fees that we earn tend to be higher in connection with international assets under management than with U.S. assets under management. Consequently, a downturn in international markets could have a significant effect on our revenues and income. Moreover, as our business grows in non-U.S. markets, any business, social and political unrest affecting these markets, in addition to any direct consequences such as unrest may have on our personnel and facilities located in the affected area, may also have a more lasting impact on the long-term investment climate in these and other areas and, as a result, our assets under management and the corresponding revenues and income that we generate from them may be negatively affected.

*Poor investment performance of our products could affect our sales or reduce the level of assets under management, potentially negatively impacting our revenues and income.* Our investment performance, along with achieving and maintaining superior distribution and client services, is critical to the success of our investment management and related services business. Strong investment performance often stimulates sales of our investment products. Poor investment performance as compared to third-party benchmarks or competitive products could lead to a decrease in sales of investment products we manage and stimulate redemptions from existing products, generally lowering the overall level of assets under management and reducing the management fees we earn. We cannot assure you that past or present investment performance in the investment products we manage will be indicative of future performance. Any poor future performance may negatively impact our revenues and income.

*We could suffer losses in earnings or revenue if our reputation is harmed.* Our reputation is important to the success of our business. The Franklin Templeton Investments brand has been, and continues to be, extremely well received both in our industry and with our clients, reflecting the fact that our brand, like our business, is based in part on trust and confidence. If our reputation is harmed, existing clients may reduce amounts held in, or withdraw entirely from, funds that we advise or funds may terminate their management agreements with us, which could reduce the amount of assets under management and cause us to suffer a corresponding loss in earnings or revenue. Moreover, reputational harm may cause us to lose current employees and we may be unable to continue to attract new ones with similar qualifications, motivations or skills. If we fail to address, or appear to fail to address, successfully and promptly the underlying causes of any reputational harm, we may be unsuccessful in repairing any existing harm to our reputation and our future business prospects would likely be affected.

*Our future results are dependent upon maintaining an appropriate level of expenses, which is subject to fluctuation.* The level of our expenses is subject to fluctuation and may increase for the following or other reasons: changes in the level and scope of our advertising expenses in response to market conditions; variations in the level of total compensation expense due to, among other things, bonuses, changes in our employee count and mix, and competitive factors; changes in expenses and capital costs, including costs incurred to maintain and enhance our administrative and operating services infrastructure; and an increase in insurance expenses including through the assumption of higher deductibles and/or co-insurance liability.

*Our ability to successfully integrate widely varied business lines can be impeded by systems and other technological limitations.* Our continued success in effectively managing and growing our business, both domestically and abroad, depends on our ability to integrate the varied accounting, financial, information and operational systems of our various businesses on a global basis. Moreover, adapting or developing our existing technology systems to meet our internal needs, as well as client needs, industry demands and new regulatory requirements, is also critical for our business. The constant introduction of new technologies presents new challenges to us. We have an ongoing need to continually upgrade and improve our various technology systems, including our data processing, financial, accounting and trading systems. Further, we also must be proactive and prepared to implement technology systems when growth opportunities present themselves, whether as a result of a business acquisition or rapidly increasing business activities in particular markets or regions. These needs could present operational issues or require, from time to time, significant capital spending. It also may require us to reevaluate the current value and/or expected useful lives of our technology systems, which could negatively impact our results of operations.

*Our inability to successfully recover should we experience a disaster or other business continuity problem could cause material financial loss, loss of human capital, regulatory actions, reputational harm or legal liability.* Should we experience a local or regional disaster or other business continuity problem, such as a pandemic or other natural or man-made disaster, our continued success will depend, in part, on the availability of our personnel, our office facilities and the proper functioning of our computer, telecommunication and other related systems and operations. While our operational size, the diversity of locations from which we operate, and our redundant back-up systems provide us with a strong advantage should we experience a local or regional disaster or other business continuity event, we could still experience near-term operational challenges, in particular depending upon how a local or regional event may affect our human capital across our operations or with regard to particular segments of our operations, such as key executive officers or personnel in our technology group. Moreover, as we grow our operations in particular areas, such as India, the potential for particular types of natural or man-made disasters, political, economic or infrastructure instabilities, or other country- or region-specific business continuity risks increases. Past disaster recovery efforts have demonstrated that even seemingly localized events may require broader disaster recovery efforts throughout our operations and, consequently, we regularly assess and take steps to improve upon our existing business continuity plans and key management succession. However, a disaster on a significant scale or affecting certain of our key operating areas within or across regions, or our inability to successfully recover should we experience a disaster or other business continuity problem, could materially interrupt our business operations and cause material financial loss, loss of human capital, regulatory actions, reputational harm or legal liability.

*Certain of the portfolios we manage, including our emerging market portfolios, are vulnerable to market-specific political, economic or other risks, any of which may negatively impact our revenues and income.* Our emerging market portfolios and revenues derived from managing these portfolios are subject to significant risks of loss from political, economic, and diplomatic developments, currency fluctuations, social instability, changes in governmental policies, expropriation, nationalization, asset confiscation and changes in legislation related to foreign ownership. Foreign trading markets,



particularly in some emerging market countries, are often smaller, less liquid, less regulated and significantly more volatile than those in the U.S. and other established markets.

*Our revenues, earnings and income could be adversely affected if the terms of our management agreements are significantly altered or these agreements are terminated by the funds we advise.* Our revenues are dependent on fees earned under investment management and related services agreements that we have with the funds we advise. These revenues could be adversely affected if these agreements are altered significantly or terminated. The decline in revenue that might result from alteration or termination of our investment management services agreements could have a material adverse impact on our earnings or income.

*Diverse and strong competition limits the interest rates that we can charge on consumer loans.* We compete with many types of institutions for consumer loans, which can provide loans at significantly below-market interest rates or in some cases zero interest rates in connection with automobile sales. Our inability to compete effectively against these companies or to maintain our relationships with the various automobile dealers through whom we offer consumer loans could limit the growth of our consumer loan business. Economic and credit market downturns could reduce the ability of our customers to repay loans, which could cause losses to our consumer loan portfolio.

*Civil litigation arising out of or relating to previously settled governmental investigations or other matters, governmental or regulatory investigations and/or examinations and the legal risks associated with our business could adversely impact our assets under management, increase costs and negatively impact our profitability and/or our future financial results.* We have been named as a defendant in shareholder class action, derivative, and other lawsuits, many of which arise out of or relate to previously settled governmental investigations. While management believes that the claims made in these lawsuits are without merit, and intends to vigorously defend against them, litigation typically is an expensive process. Risks associated with legal liability often are difficult to assess or quantify and their existence and magnitude can remain unknown for significant periods of time. Moreover, settlements or judgments against us have the potential of being substantial if we are unsuccessful in settling or otherwise resolving matters early in the process and/or on favorable terms. It is also possible that we may be named as a defendant in additional civil or governmental actions similar to those already instituted. From time to time we may receive requests for documents or other information from governmental authorities or regulatory bodies or we also may become the subject of governmental or regulatory investigations and/or examinations. Moreover, governmental or regulatory investigations or examinations that have been inactive could become active. We may be obligated, and under our standard form of indemnification agreement with certain officers and directors in some instances we are obligated, or we may choose, to indemnify directors, officers or employees against liabilities and expenses they may incur in connection with such matters to the extent permitted under applicable law. Eventual exposures from and expenses incurred relating to current and future litigation, investigations, examinations and settlements could adversely impact our assets under management, increase costs and negatively impact our profitability and/or our future financial results. Judgments or findings of wrongdoing by regulatory or governmental authorities or in civil litigation against us could affect our reputation, increase our costs of doing business and/or negatively impact our revenues, any of which could have a material negative impact on our financial results.

*Our ability to meet cash needs depends upon certain factors, including our asset value, credit worthiness and the market value of our stock.* Our ability to meet anticipated cash needs depends upon factors including our asset value, our creditworthiness as perceived by lenders and the market value of our stock. Similarly, our ability to securitize and hedge future loan portfolios and credit card receivables, and to obtain continued financing for certain Class C shares, is also subject to the market's perception of those assets, finance rates offered by competitors, and the general market for private debt. If we are unable to obtain these funds and financing, we may be forced to incur unanticipated costs or revise our business plans.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

In the normal course of business, our financial position is subject to market risk: the potential loss due to changes in the value of financial instruments including those resulting from adverse changes in interest rates, foreign currency exchange and equity prices. Financial instruments include, but are not limited to, trade accounts receivable, investment securities, deposits and other debt obligations. Management is responsible for managing market risk. Our Enterprise Risk Management Committee is responsible for providing a framework to assist management to identify, assess and manage market and other risks.

Our banking/finance operating segment is exposed to interest rate fluctuations on its loans receivable, debt securities held, and deposit liabilities. In our banking/finance operating segment, we monitor the net interest rate margin and the average maturity of interest earning assets, as well as funding sources.

Our investment management and related services operating segment is exposed to changes in interest rates, primarily through its investment in debt securities and its outstanding debt. We minimize the impact of interest rate fluctuations related to our investments in debt securities by managing the maturities of these securities, and through diversification. In addition, we seek to minimize the impact of interest rate changes on our outstanding debt by entering into financing transactions that ensure an appropriate mix of debt at fixed and variable interest rates.





At December 31, 2006, we have considered the potential impact of a 2% movement in market interest rates in relation to the banking/finance segment interest earning assets, net of interest-bearing liabilities, total debt outstanding and our portfolio of debt securities, individually and in the aggregate. Based on our analysis, we do not expect that this change would have a material impact on our operating revenues or results of operations, either individually or in the aggregate.

Our foreign operations expose us to foreign currency exchange risk. While we operate primarily in the United States, we also provide services and earn revenues in Canada, The Bahamas, Europe, Asia, South and Central America, Africa and Australia. Our exposure to foreign currency exchange risk is minimized since a significant portion of these revenues and associated expenses are denominated in U.S. dollars. This situation may change in the future as our business continues to grow outside the United States.

We are exposed to equity price fluctuations through securities we hold that are carried at fair value and through investments held by majority-owned sponsored investment products that we consolidate, which are also carried at fair value. To mitigate this risk, we maintain a diversified investment portfolio. Our exposure to equity price fluctuations is also minimized as we sponsor a broad range of investment products in various global jurisdictions, which allows us to mitigate the impact of changes in any particular market(s) or region(s). The following is a summary of the effect of a 10% increase or decrease in equity prices on our financial instruments subject to equity price fluctuations at December 31, 2006.

| <i>(in thousands)</i>                     | Carrying Value      | Carrying Value          |                         |
|---|---------------------|-------------------------|-------------------------|
|   |                     | Assuming a 10% Increase | Assuming a 10% Decrease |
| <b>Current</b>                            |                     |                         |                         |
| Investment securities, trading            | \$ 418,407          | \$ 460,247              | \$ 376,566              |
| Investment securities, available-for-sale | 584,524             | 642,977                 | 526,072                 |
| <b>Total Current</b>                      | <b>\$ 1,002,931</b> | <b>\$ 1,103,224</b>     | <b>\$ 902,638</b>       |
| <b>Banking/Finance</b>                    |                     |                         |                         |
| Investment securities, available-for-sale | \$ 137,581          | \$ 151,339              | \$ 123,823              |
| <b>Non-Current</b>                        |                     |                         |                         |
| Investment in equity-method investees     | \$ 236,987          | \$ 260,686              | \$ 213,288              |
| Equities and other                        | 263,584             | 289,942                 | 237,226                 |
| <b>Total Non-Current</b>                  | <b>\$ 500,571</b>   | <b>\$ 550,628</b>       | <b>\$ 450,514</b>       |

**Item 4. Controls and Procedures.**

The Company's management evaluated, with the participation of the Company's principal executive and principal financial officers, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of December 31, 2006. Based on their evaluation, the Company's principal executive and principal financial officers concluded that the Company's disclosure controls and procedures as of December 31, 2006 were designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Exchange Act is (i) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and (ii) accumulated and communicated to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.

There has been no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the Company's quarter ended December 31, 2006, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

As previously reported, the Company and certain of its subsidiaries have been named in multiple lawsuits alleging violations of federal securities and state laws relating to marketing support payments and/or payment of allegedly excessive commissions, and/or advisory or distribution fees. These lawsuits are styled as class actions and/or derivative actions brought on behalf of certain Funds, and seek, among other relief, monetary damages, restitution, an accounting of all fees, commissions and soft dollar payments, declaratory relief, injunctive relief, and/or attorneys' fees and costs. The Company and certain of its subsidiaries were named in an additional such lawsuit, filed on December 22, 2006, in the United States District Court for the Northern District of California, and captioned *Ulferts v. Franklin Resources, Inc., et al.*, Case No. 06-7847 SI.

Management strongly believes that the claims made in the lawsuit identified above are without merit and intends to defend against them vigorously. The Company cannot predict with certainty, however, the eventual outcome of the lawsuit, nor whether it will have a material negative impact on the Company.

The Company is from time to time involved in litigation relating to claims arising in the normal course of business. Management is of the opinion that the ultimate resolution of such claims will not materially affect the Company's business or financial position.

Other than as noted above, there have been no other material changes to the matters discussed in Part I, Item 3 "Legal Proceedings" in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

**Item 1A. Risk Factors.**

Our Annual Report on Form 10-K for the fiscal year ended September 30, 2006 includes a detailed discussion of our risk factors. The information presented below sets out a material amendment to one of our prior risk factors included in our previously filed reports, and should be read in conjunction with the risk factors and information disclosed in our Annual Report on Form 10-K.

*We face risks, and corresponding potential costs and expenses, associated with conducting operations and growing our business in numerous foreign countries.* We sell mutual funds and offer investment management and related services in many different regulatory jurisdictions around the world, and intend to continue to expand our operations internationally. As we do so, we will continue to face various ongoing challenges to ensure that we have sufficient resources, procedures and controls in place to address and ensure that our operations abroad operate consistently and effectively. In order to remain competitive, we must be proactive and prepared to implement necessary resources when growth opportunities present themselves, whether as a result of a business acquisition or rapidly increasing business activities in particular markets or regions. As we grow, we face a heightened risk that the necessary resources and/or personnel will be unavailable to take full advantage of strategic opportunities when they appear or that strategic decisions can be efficiently implemented. Local regulatory environments may vary widely, as may the adequacy and sophistication of each. Similarly, local distributors, and their policies and practices as well as financial viability, may be inconsistent or less developed or mature. Notwithstanding potential long-term cost savings by increasing certain operations, such as transfer agent and other back-office operations, in countries or regions of the world with lower operating costs, growth of our international operations may involve near-term increases in expenses as well as additional capital costs, such as information, systems and technology costs and costs related to compliance with particular regulatory or other local requirements or needs. Local requirements or needs may also place additional demands on sales and compliance personnel and resources, such as meeting local language requirements while also integrating personnel into an organization with a single operating language. Finding and hiring additional, well-qualified personnel and crafting and adopting policies, procedures and controls to address local or regional requirements remain a challenge as we expand our operations internationally. Moreover, regulators in non-U.S. jurisdictions could also change their policies or laws in a manner that might restrict or otherwise impede our ability to distribute or register investment products in their respective markets. Any of these local requirements, activities or needs could increase the costs and expenses we incur in a specific jurisdiction without any corresponding increase in revenues and income from operating in the jurisdiction. In addition, from time to time we enter into foreign-based joint ventures in which we may not have legal control. These investments in joint ventures may involve risks, including the risk that the controlling joint venture partner may have business interests, strategies or goals that are inconsistent with ours, and the risk that business decisions or other actions or omissions of the controlling joint venture partner or the joint venture company may result in harm to our reputation or adversely affect the value of our investment in the joint venture.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

The following table provides information with respect to the shares of the Company's common stock we repurchased during the three months ended December 31, 2006.

| Period                                     | Total<br>Number of<br>Shares<br>Purchased | Average Price<br>Paid per<br>Share | Total Number<br>of Shares<br>Purchased as Part<br>of Publicly<br>Announced Plans<br>or Programs | Maximum   |
|--|---|------------------------------------|---|---|
|  |   |                                    |   | Number of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the Plans<br>or Programs |
| October 1, 2006 through October 31, 2006   | 536,249                                   | \$ 110.89                          | 536,249   | 8,908,564   |
| November 1, 2006 through November 30, 2006 | 323                                       | 106.23                             | 323   | 8,908,241   |
| December 1, 2006 through December 31, 2006 | 125,000                                   | 113.74                             | 125,000   | 8,783,241   |
| <b>Total</b>                               | <b>661,572</b>                            |                                    | <b>661,572</b>  |   |

Under our stock repurchase program, we can repurchase shares of the Company's common stock from time to time in the open market and in private transactions in accordance with applicable laws and regulations, including without limitation applicable federal securities laws. From time to time we have announced the existence of the Company's continuing policy of purchasing shares of its common stock, including announcements made in March 2000, August 2002, May 2003, August 2003 and July 2006. From the fiscal year ended September 30, 2002 through December 31, 2006, our Board of Directors had authorized and approved the repurchase of up to 40.0 million shares under our stock repurchase program, of which 8.8 million shares of our common stock remained available for repurchase at December 31, 2006. Our stock repurchase program is not subject to an expiration date.

**Item 6. Exhibits.**

| Exhibit No.     | Description   |
|-----------------|---|
| Exhibit 3(i)(a) | Registrant's Certificate of Incorporation, as filed November 28, 1969, incorporated by reference to Exhibit (3)(i) to the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 1994 (File No. 001-09318) (the 1994 Annual Report).      |
| Exhibit 3(i)(b) | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed March 1, 1985, incorporated by reference to Exhibit (3)(ii) to the 1994 Annual Report.  |
| Exhibit 3(i)(c) | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed April 1, 1987, incorporated by reference to Exhibit (3)(iii) to the 1994 Annual Report.   |
| Exhibit 3(i)(d) | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed February 2, 1994, incorporated by reference to Exhibit (3)(iv) to the 1994 Annual Report.   |
| Exhibit 3(i)(e) | Registrant's Certificate of Amendment of Certificate of Incorporation, as filed on February 4, 2005, incorporated by reference to Exhibit (3)(i)(e) to the Company's Quarterly Report on Form 10-Q for the period ended December 31, 2004 (File No. 001-09318). |
| Exhibit 3(ii)   | Registrant's Amended and Restated By-laws of Franklin Resources, Inc. adopted October 11, 2005, incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed with the SEC on October 14, 2005 (File No. 001-09318).                                 |
| Exhibit 10.1    | Form of Notice of Restricted Fund Unit Award and Restricted Fund Unit Award Agreement (standard), incorporated by reference to Exhibit 10.1 to Franklin Resources, Inc.'s Current Report on Form 8-K filed with the SEC on November 8,                          |

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2006 (the November 8, 2006 Form 8-K ).\*

- Exhibit 10.2 Form of Notice of Restricted Fund Unit Award and Restricted Fund Unit Award Agreement (other), incorporated by reference to Exhibit 10.2 to the November 8, 2006 Form 8-K.\*
- Exhibit 10.3 Form of Notice of Restricted Stock Award and Restricted Stock Award Agreement, incorporated by reference to Exhibit 10.3 to the November 8, 2006 Form 8-K.\*
- Exhibit 10.4 Form of Notice of Restricted Stock Unit Award and Restricted Stock Unit Award Agreement, incorporated by reference to Exhibit 10.4 to the November 8, 2006 Form 8-K.\*
- Exhibit 10.5 Description of Bonus Payments to Certain Current Executive Officers and One Former Executive Officer of Franklin Resources, Inc., incorporated by reference to Exhibit 10.5 to the November 8, 2006 Form 8-K.\*

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| <b>Exhibit No.</b> | <b>Description</b>  |
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| Exhibit 10.6       | Named Executive Officer Compensation as of November 21, 2006, incorporated by reference to Exhibit 10.91 of Franklin Resources, Inc. s Annual Report on Form 10-K for the fiscal year ended September 30, 2006.*  |
| Exhibit 10.7       | Franklin Resources, Inc. 1998 Employee Stock Investment Plan, as amended and restated December 13, 2006, incorporated by reference to Exhibit 10.1 to Franklin Resources, Inc. s Current Report on Form 8-K filed with the SEC on December 22, 2006 (the December 22, 2006 Form 8-K ).* |
| Exhibit 10.8       | Franklin Resources, Inc. Amended and Restated Annual Incentive Compensation Plan (amended and restated December 13, 2006), incorporated by reference to Exhibit 10.2 to the December 22, 2006 Form 8-K.*  |
| Exhibit 10.9       | Franklin Resources, Inc. 2004 Key Executive Incentive Compensation Plan, as amended December 13, 2006, incorporated by reference to Exhibit 10.3 to the December 22, 2006 Form 8-K.   |
| Exhibit 10.10      | Non-Employee Director Compensation as of December 31, 2006.*  |
| Exhibit 31.1       | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).  |
| Exhibit 31.2       | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).  |
| Exhibit 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 (furnished herewith).   |
| Exhibit 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 (furnished herewith).   |

\* Management Contract or Compensatory Plan or Arrangement.

**SIGNATURES**

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.

**FRANKLIN RESOURCES, INC.**

(Registrant)

Date: February 9, 2007

By: /s/ KENNETH A. LEWIS

**Kenneth A. Lewis**

**Senior Vice President,**

**Chief Financial Officer and Treasurer**

**(Duly Authorized Officer and**

**Principal Financial Officer)**

Page 42

**EXHIBIT INDEX**

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