

Southwest Securities, Inc. (a wholly owned subsidiary of SWS Group, Inc.)

**STATEMENT OF FINANCIAL CONDITION**

December 31, 2010

*(In thousands, except par, redemption values and share amounts)*

*(unaudited)*

**Assets**

Cash	\$	6,066
Assets segregated for regulatory purposes		254,134
Receivable from brokers, dealers and clearing organizations		1,929,588
Receivable from clients		237,693
Securities owned, at market value		228,509
Securities purchased under agreements to resell		30,600
Fixed assets, at cost, less accumulated depreciation of \$31,732		12,442
Goodwill		7,552
Intangible, net of accumulated amortization of \$4,661		399
Other assets (including \$9,064 due from affiliates)		35,191
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Total assets	\$	<u>2,742,174</u>

**Liabilities and Stockholder's Equity**

Short-term borrowings	\$	200,300
Payable to brokers, dealers, and clearing organizations		1,789,206
Payable to clients		394,868
Drafts payable		29,033
Securities sold, not yet purchased, at market value		79,583
Securities sold under agreements to repurchase		2,513
Accrued expenses and other liabilities (including \$1,331 due to affiliates)		43,903
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		<u>2,539,406</u>

**Stockholder's equity:**

Series A preferred stock, \$20 par value, \$1,000 redemption value; authorized 100,000 shares; no shares issued and outstanding	-
Class A voting common stock of \$1 par value; authorized 10,000 shares; issued and outstanding 2,820 shares	3
Class B nonvoting common stock of \$1 par value; authorized 10,000 shares; none issued	-
Additional paid-in capital	32,340
Retained earnings	170,425
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	<u>202,768</u>
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Total liabilities and stockholder's equity	\$ <u>2,742,174</u>

*See accompanying Notes to Statement of Financial Condition.*

Southwest Securities, Inc. (a wholly owned subsidiary of SWS Group, Inc.)

**Notes to Statement of Financial Condition**

December 31, 2010

*(In thousands, except par, redemption values and share amounts)*

*(unaudited)*

**1. ORGANIZATION**

Southwest Securities, Inc. ("Company"), a wholly owned subsidiary of SWS Group, Inc. ("Parent"), is a registered broker/dealer in securities under the Securities Exchange Act of 1934 ("Act").

Pursuant to the Securities and Exchange Commission's ("SEC") Rule 11(a) of the Act, over 50% of the Company's revenues are comprised of Section 11(a) items, indicating the Company is primarily engaged in trading on behalf of customers.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Securities transactions**

Proprietary securities transactions are recorded on the trade date, as if they had settled. Customers' securities and commodities transactions are reported on a settlement date basis with related commission income and expenses reported on a trade date basis.

Amounts receivable and payable for securities transactions that have not reached their contractual settlement date are recorded net on the statement of financial condition.

Marketable securities are valued at market value, based on quoted market prices, and securities not readily marketable are valued at fair value as determined by management.

**Fixed assets**

Fixed assets are comprised of automobiles (\$65), furniture and equipment (\$32,755), and leasehold improvements (\$11,354) which are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets (3 to 15 years). Additions, improvements and expenditures for repairs and maintenance that significantly extend the life of an asset are capitalized.

**Goodwill**

The Company performed its annual assessment of the fair value of goodwill in June of fiscal 2010, and based on the results of the assessment, the Company's goodwill balance was not impaired. The Company bases its assessment of the fair value of the Company's business units with goodwill, clearing and institutional brokerage, on a weighted average of a discounted cash flow model estimate of fair value and a market multiple approach to fair value.

**Resale and repurchase agreements**

Transactions involving purchases of securities under agreements to resell (reverse repurchase agreements or reverse repos) or sales of securities under agreements to repurchase (repurchase agreements or repos) are accounted for as collateralized financings except where the Company does not have an agreement to sell (or purchase) the same or substantially the same securities before maturity at a fixed or determinable price. It is the policy of the Company to obtain possession of collateral with a market value equal to or in excess of the principal amount loaned under resale agreements. Collateral is valued daily, and the Company may require counterparties to deposit additional collateral or return collateral pledged when appropriate.

**Securities-lending activities**

Securities borrowed and securities loaned transactions are generally reported as collateralized financings except where letters of credit or other securities are used as collateral. Securities borrowed transactions require the Company to deposit cash, letters of credit, or other collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash in

an amount generally in excess of the market value of securities loaned. The Company monitors the market value of securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary.

### **Drafts payable**

In the normal course of business, the Company uses drafts to make payments relating to its brokerage transactions. These drafts are presented for payment through an unaffiliated bank and are sent to the Company daily for review and acceptance. Upon acceptance, the drafts are paid and charged against cash.

### **Federal Income Taxes**

The Company files a consolidated federal income tax return with its Parent. For purposes of the statement of financial condition, current income taxes are computed as if the Company filed a separate entity income tax return.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

At December 31, 2010, the Company had approximately \$1,283 of unrecognized tax benefits. The Company's net liability increased \$120 from June 25, 2010 to December 31, 2010 due to the expiration of the statute of limitations for unrecognized tax benefits related to tax positions taken on previously filed returns. While the Company expects that the net liability for uncertain tax positions will change during the next twelve months, the Company does not believe that the change will have a significant impact on its financial position.

Included in the net liability at December 31, 2010 was accrued interest and penalties of \$217, net of federal benefit. At December 31, 2010, the total amount of unrecognized income tax benefits that, if recognized, would reduce income tax expense was approximately \$1,066, net of federal benefit.

With limited exceptions, the Company is no longer subject to U.S. federal, state or local tax audits by taxing authorities for tax years preceding 2006. The examination of the Company's returns by a state agency for the tax years ended December 31, 2006 through 2008 was concluded with no material adjustments.

### **Fair Value of Financial Instruments**

Fair value accounting establishes a framework for measuring fair value and expands disclosures about fair value measurements. Under fair value accounting, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the primary market in which the reporting entity transacts. The standard clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. Under the standard, fair value measurements are separately disclosed by level within the fair value hierarchy. The standard describes three levels of inputs that may be used to measure fair value:

- *Level 1* — Quoted prices in an active market for identical assets or liabilities. Assets and liabilities utilizing Level 1 inputs include the Company's investment in government guaranteed bonds purchased under the Temporary Liquidity Guarantee Program ("TLGP") and certain inventories held in the Company's securities owned and securities sold, not yet purchased portfolio. Valuation of these instruments does not require a high degree of

judgment as the valuations are based on quoted prices in active markets that are readily available.

- *Level 2* — Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Assets and liabilities utilizing Level 2 inputs include certain inventories held in the Company's securities owned and securities sold, not yet purchased portfolio. These financial instruments are valued using quoted prices that are less frequent than those in active markets or by models that use various assumptions that are derived from or supported by data that is generally observable in the marketplace. Valuations in this category are inherently less reliable than quoted market prices due to the degree of subjectivity involved in determining appropriate methodologies and the applicable underlying observable market assumptions.
- *Level 3* — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. Assets and liabilities utilizing Level 3 inputs include certain inventories held in the Company's securities owned portfolio. These financial instruments have significant inputs that cannot be validated by readily determinable market data and generally involve considerable judgment by management.

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying statement of financial condition, as well as the general classification of such instruments pursuant to the valuation hierarchy.

***Assets Segregated for Regulatory Purposes.*** Because quoted market prices are available in an active market, these securities are classified within Level 1 of the valuation hierarchy. These securities consist of government bonds purchased under the TLGP.

***Securities Owned and Securities Sold, Not Yet Purchased Portfolio.*** Securities classified as Level 1 securities primarily consist of financial instruments whose value is based on quoted market prices such as corporate equity securities and U.S. government obligations.

Securities classified as Level 2 securities include financial instruments that are valued using models or other valuation methodologies. These models are primarily industry standard models that consider various assumptions, including time value, yield curve, volatility factors, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Securities in this category include corporate debt, certain U.S. government and government agency obligations and municipal obligations.

Securities classified as Level 3 securities are securities whose fair value is estimated based on internally developed models or methodologies, including discounted cash flow, utilizing significant inputs that are generally less readily observable. Included in this category are certain corporate equity securities and municipal auction rate securities.

At December 31, 2010, the Company held one municipal auction rate bond with a par amount of \$23,300. This security is an investment grade credit, was valued at 95.7% of par, or \$22,298, at December 31, 2010, and yielded less than 1% per year. The interest rate on the bond is based on the LIBOR rate. The discount on the value of the bond is due to a lack of marketability. While management does not expect any reduction in the cash flow from this bond, the disruption in the credit markets has led to auction failures. The Company currently has the ability to hold this investment until maturity. While the Company expects the issuer of this bond to refinance the debt when LIBOR interest rates rise, there can be no certainty that this refinancing will occur. The Company believes the valuation of this bond at 95.7% of

par at December 31, 2010 reflected an appropriate discount for the current lack of liquidity in this investment.

Substantially all of the Company's financial assets and liabilities are carried at market value or at amounts which, because of their short-term nature, approximate current fair value.

### **Use of estimates**

The preparation of the statement of financial condition in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the statement of financial condition. Actual results could differ from those estimates.

### **3. CASH**

The company considers cash to include cash on hand and in depository accounts. In addition, highly liquid debt instruments purchased with original maturities of three months or less, when acquired, are considered to be cash equivalents. The Federal Deposit Insurance Corporation ("FDIC") insures accounts up to \$250. In accordance with the Dodd-Frank Act, non-interest bearing transaction accounts are temporarily covered under FDIC insurance until December 31, 2012. As a result, at December 31, 2010, cash balances did not exceed the federally insured limit. At-risk amounts are subject to fluctuation on a daily basis and management does not believe there is significant risk with respect to such deposits.

### **4. ASSETS SEGREGATED FOR REGULATORY PURPOSES**

At December 31, 2010, the Company held TLGP bonds with a market value of \$61,751 and cash of approximately \$192,383 segregated in special reserve bank accounts for the exclusive benefit of customers under Exchange Act Rule 15c3-3. The Company had no reserve deposits in special reserve bank accounts for the Proprietary Accounts of Introducing Brokers ("PAIB") at December 31, 2010.

### **5. RECEIVABLE FROM AND PAYABLE TO BROKERS, DEALERS AND CLEARING ORGANIZATIONS**

At December 31, 2010, the Company had receivable from and payable to brokers, dealers and clearing organizations related to the following:

#### Receivable:

Securities failed to deliver	\$	22,392
Securities borrowed		1,769,456
Correspondent broker/dealers		67,340
Clearing organizations		20,815
Other		49,585
	\$	<u>1,929,588</u>

#### Payable:

Securities failed to receive	\$	21,389
Securities loaned		1,744,220
Correspondent broker/dealers		12,567
Other		11,030
	\$	<u>1,789,206</u>

Securities failed to deliver and receive represent the contract value of securities that have not been delivered or received subsequent to settlement date.

The Company clears securities transactions for correspondent broker/dealers. Proprietary settled principal securities and related transactions for these correspondents are included in the receivable from and payable to brokers, dealers and clearing organizations. The Company holds collateral for the receivables from correspondents in the amount of \$86,932.

The Company participates in the securities borrowing and lending business by borrowing and lending securities other than those of its clients. Securities borrowed and loaned represent deposits made to or received from other broker/dealers relating to these transactions. These deposits approximate the market value of the underlying securities. All open positions are adjusted to market values daily. The Company obtains or releases collateral as prices of the underlying securities fluctuate. At December 31, 2010, the Company has received collateral of approximately \$1,769,456 under securities lending agreements, of which the Company has repledged approximately \$1,689,234.

## **6. RECEIVABLE FROM AND PAYABLE TO CLIENTS**

Receivable from and payable to clients include amounts due on cash and margin transactions. Included in these amounts are receivable from and payable to noncustomers (as defined by Rule 15c3-3 of the Act, principally officers, directors and related accounts), which aggregated approximately \$1,316 and \$291, respectively, at December 31, 2010. Securities accounts of noncustomers are subject to the same terms and regulations as those of customers. Securities owned by customers and noncustomers that collateralize the receivables are not reflected in the accompanying statement of financial condition.

The Company pledges client securities as collateral in conjunction with the Company's securities lending activities. At December 31, 2010, the Company has approximately \$309,466 of client securities under customer margin loans that are available to be pledged, of which the Company has repledged approximately \$54,986 under securities loan agreements.

The Company pays interest on certain customer "free credit" balances available for reinvestment. The aggregate balance of such funds was approximately \$338,461 at December 31, 2010. During fiscal year 2011, the interest rates paid on these balances ranged from 0.05% to 0.09%. While the Company pays interest on these funds at varying rates, the rate paid at December 31, 2010 was 0.05%. The weighted average interest rate paid during fiscal 2011 was 0.06%.

The Company maintains an allowance for doubtful accounts of \$325 which represents amounts, in the judgment of management, that are necessary to adequately absorb losses from known and inherent risks in receivables from customers. At December 31, 2010, all unsecured customer receivables had been provided for in this allowance.

## 7. SECURITIES OWNED AND SECURITIES SOLD, NOT YET PURCHASED

At December 31, 2010, securities owned and securities sold, not yet purchased, both of which are carried at market value, consist of the following:

### Securities owned:

U.S. government and government agency obligations	\$ 18,298
Municipal obligations	126,890
Corporate equity securities	11,185
Corporate obligations	62,155
Other	9,981
	<u>\$ 228,509</u>

### Securities sold, not yet purchased:

U.S. government and government agency obligations	\$ 45,703
Corporate equity securities	493
Corporate obligations	32,282
Other	1,105
	<u>\$ 79,583</u>

Certain of the above securities have been pledged as security deposits at clearing organizations for the Company's clearing business. These pledged securities amounted to approximately \$3,448 at December 31, 2010. Additional securities have been pledged to secure short-term borrowings, see Note 11.

## 8. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table summarizes by level within the fair value hierarchy "Assets segregated for regulatory purposes," "Securities owned, at market value" and "Securities sold, not yet purchased, at market value" as of December 31, 2010:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>Assets segregated for regulatory purposes</b>				
U.S. government guaranteed obligations	\$ 61,751	\$ -	\$ -	\$ 61,751
	<u>\$ 61,751</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 61,751</u>
<b>Securities owned, at market value</b>				
U.S. government and government agency obligations	\$ 4,015	\$ 14,283	\$ -	\$ 18,298
Municipal obligations	-	104,592	22,298	126,890
Corporate equity securities	9,360	-	1,825	11,185
Corporate obligations	-	62,155	-	62,155
Other	223	9,758	-	9,981
	<u>\$ 13,598</u>	<u>\$ 190,788</u>	<u>\$ 24,123</u>	<u>\$ 228,509</u>

	Level 1	Level 2	Level 3	Total
<b>Securities sold, not yet purchased, at market value</b>				
U.S. government and government agency obligations	\$ 45,631	\$ 72	\$ -	\$ 45,703
Corporate equity securities	493	-	-	493
Corporate obligations	-	32,282	-	32,282
Other	46	1,059	-	1,105
	<u>\$ 46,170</u>	<u>\$ 33,413</u>	<u>\$ -</u>	<u>\$ 79,583</u>

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

	Corporate Equity Securities	Municipal Obligations	Total
<b>Ending balance at June 25, 2010</b>	\$ 1,841	\$ 22,298	\$ 24,139
Unrealized gains	2	-	2
Sales	(18)	-	(18)
<b>Ending balance at December 31, 2010</b>	<u>\$ 1,825</u>	<u>\$ 22,298</u>	<u>\$ 24,123</u>

## 9. SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL

At December 31, 2010, the Company held reverse repurchase agreements totaling \$30,600, collateralized by U.S. government and government agency obligations with a market value of approximately \$30,638.

## 10. INTANGIBLE ASSET

In July, 2006, the Company purchased the correspondent customers of TD Ameritrade Holding Corporation ("Ameritrade"), for an aggregate purchase price of \$5,060. The Company recorded a customer relationship intangible of \$5,060 in connection with this transaction. The intangible asset is amortized over a five year period at a rate based on the estimated future economic benefit of the customer relationships. The Company performed an asset impairment analysis of the intangible asset in June of fiscal 2010 and based on its analysis, the Company's intangible balance was not impaired.

## 11. SHORT-TERM BORROWINGS

The Company has credit arrangements with commercial banks, which include broker loan lines up to \$300,000 at December 31, 2010. These lines of credit are used primarily to finance securities owned, securities held for correspondent broker/dealer accounts, receivables in customers' margin accounts and underwriting activities. The lines may also be used to release pledged collateral against day loans. These credit arrangements are provided on an "as offered" basis and are not committed lines of credit. These arrangements can be terminated at any time by the lender. Any outstanding balances under these credit arrangements are due on demand and bear interest at rates indexed to the federal funds rate (0.25% at December 31, 2010). At December 31, 2010, the amount outstanding under these secured arrangements was \$156,000, which was collateralized by securities held for firm accounts valued at \$137,837 and securities held for correspondent accounts valued at \$67,474.

Additionally, the Company has an irrevocable letter of credit agreement aggregating \$50,000 at December 31, 2010, pledged to support its open option positions with an options clearing organization. The letter of credit bears interest at the broker call rate, if drawn, and is renewable

semi-annually. This letter of credit is fully collateralized by marketable securities held in customers and noncustomers margin accounts with values of approximately \$64,444 at December 31, 2010.

The Company had \$250 outstanding under unsecured letters of credit agreements at December 31, 2010, pledged to support its open positions with securities clearing organizations. The letters of credit bear a 1% commitment fee and are renewable semi-annually.

The Company also had \$500 outstanding under an unsecured letter of credit at December 31, 2010, pledged to support its underwriting activities. The letter of credit bears a 1% commitment fee and is renewable annually at the Company's option.

In addition to the broker lines, at December 31, 2010, the Company has a \$10,000 unsecured line of credit that is due on demand and bears interest at rates indexed to the federal funds rate. This credit arrangement is provided on an "as offered" basis and is not a committed line of credit. The total amount of borrowings available under this line of credit is reduced by the amount outstanding on the line and under any unsecured letters of credit at the time of borrowing. At December 31, 2010, there were no amounts outstanding on this line, other than the \$750 under unsecured letters of credit, referenced above. At December 31, 2010, the total amount available for borrowing was \$9,250.

On January 29, 2010, the Company entered into an agreement with an unaffiliated bank for a \$50,000 committed revolving credit facility. The facility includes up to \$15,000 in unsecured credit. The commitment fee is 37.5 basis points and when drawn, the interest rate is equal to the federal funds rate plus 75 basis points. The agreement provides that the Company must maintain tangible net worth of \$150,000. As of December 31, 2010, there was \$44,300 outstanding under the committed revolving credit facility, of which no amounts were unsecured. The \$44,300 of secured borrowings was collateralized by securities with a value of \$70,190 at December 31, 2010. On January 28, 2011, the Company renewed this facility. The new facility provides up to \$45,000 of secured borrowings.

In addition to using customer securities to collateralize bank loans, the Company also loans client securities as collateral in conjunction with its securities lending activities. At December 31, 2010, approximately \$309,466 of client securities under customer margin loans was available to be pledged, of which the Company had pledged \$54,986 under securities loan agreements.

## **12. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE**

Securities sold under repurchase agreements, which are secured borrowings, generally mature within one to four days from the transaction date. Securities sold under repurchase agreements are reflected at the amount of cash received in connection with the transactions. The Company may be required to provide additional collateral based on the fair value of the underlying securities. The Company monitors the fair value of the underlying securities on a daily basis. Securities sold under repurchase agreements at December 31, 2010 was \$2,513.

## **13. INCOME TAXES**

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2010 are presented below:

Deferred tax assets:	
Accrued expenses	\$ 6,936
State deferred taxes	\$ 1,259
Other	<u>1,031</u>
Total gross deferred tax asset	<u>9,226</u>
Deferred tax liabilities:	
Fixed assets	<u>(1,183)</u>
Net deferred tax asset included in other assets	<u>\$ 8,043</u>

As a result of the Company's history of taxable income and the nature of the items from which deferred tax assets are derived, management believes that it is more likely than not that the Company will realize the benefit of the deferred tax assets.

The current income tax payable at December 31, 2010 was \$3,734.

#### 14. NET CAPITAL REQUIREMENTS

The Company is subject to the Securities and Exchange Commission's Uniform Net Capital Rule (the "Rule"), which requires the maintenance of minimum net capital. The Company has elected to use the alternative method, permitted by the Rule, which requires that it maintain minimum net capital, as defined in Rule 15c3-1, equal to the greater of \$1,000 or 2% of aggregate debit balances, as defined in Rule 15c3-3 pursuant to the Act. At December 31, 2010, the Company had net capital of approximately \$121,597 which is approximately \$115,105 in excess of its minimum net capital requirement of approximately \$6,492 at that date. Additionally, the net capital rule of the NYSE provides that equity capital may not be withdrawn or cash dividends paid if resulting net capital would be less than 5% of aggregate debit items. At December 31, 2010, the Company had net capital of approximately \$105,367 in excess of 5% of aggregate debit items.

#### 15. AFFILIATE TRANSACTIONS

The Company clears all customer transactions for SWS Financial Services, Inc ("SWSFS"), an affiliate. The Company also provides all accounting, administrative services, management services and office facilities to SWSFS in accordance with an expense sharing agreement.

Clients and correspondents of the Company have the option to invest in an interest bearing checking account and sub-savings account called Bank Insured Deposits at the Company's banking affiliate, Southwest Securities, FSB. These funds are FDIC insured up to \$250.

#### 16. COMMITMENTS AND CONTINGENCIES

The Company leases its offices and certain equipment under noncancelable operating lease agreements. At December 31, 2010 the future rental payments for the noncancelable operating leases for each of the following five fiscal years and thereafter follows:

2011	\$ 5,384
2012	4,701
2013	3,744
2014	2,710
2015	2,061
Thereafter	<u>1,147</u>
	<u>\$ 19,747</u>

Through its participation in underwriting, both corporate and municipal, the Company could expose itself to material risk since the possibility exists that securities that the Company has committed to purchase cannot be sold at the initial offering price. Federal and state securities laws and regulations also affect the activities of underwriters and impose substantial potential liabilities for violations in connection with sales of securities by underwriters to the public. There were no potential liabilities due under outstanding underwriting arrangements at December 31, 2010.

In the general course of its brokerage business and the business of clearing for other brokerage firms, the Company has been named as a defendant in various lawsuits and arbitration proceedings. These claims allege violation of federal and state securities laws. Management believes that resolution of these claims will not result in any material adverse effect on the Company's financial position. Included in accrued expenses and other liabilities is \$1,897 for such claims.

The Company provides representations and warranties to counterparties in connection with a variety of commercial transactions and occasionally indemnifies them against potential losses caused by the breach of those representation and warranties. These indemnifications generally are standard contractual indemnifications and are entered into in the normal course of business. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these arrangements and has not recorded any contingent liability in the statement of financial condition for these indemnifications.

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

#### **17. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK**

In the normal course of business, the Company engages in activities involving the execution, settlement and financing of various securities transactions. These activities may expose the Company to off-balance sheet credit and market risks in the event the customer or counterparty is unable to fulfill its contractual obligation. Such risks may be increased by volatile trading markets.

As part of its normal brokerage activities, the Company sells securities not yet purchased (short sales) for its own account. The establishment of short positions exposes the Company to market risk in the event prices increase, as the Company may be obligated to acquire the securities at prevailing market prices.

The Company seeks to control the risks associated with its customers' activities, including customer accounts of its correspondents for which it provides clearing services, by requiring customers to maintain margin collateral in compliance with various regulatory and internal guidelines. The required margin levels are monitored daily and, pursuant to such guidelines, customers are required to deposit additional collateral or to reduce positions when necessary.

A portion of the Company's customer activity involves short sales and the writing of option contracts. Such transactions may require the Company to purchase or sell financial instruments at prevailing market prices in order to fulfill the customers' obligations.

At times, the Company lends money using reverse repurchase agreements. All positions are collateralized by U.S. government or U.S. government agency securities. Such transactions may expose the Company to off-balance sheet risk in the event such borrowers do not repay the loans and

the value of collateral held is less than that of the underlying receivable. These agreements provide the Company with the right to maintain the relationship between market value of the collateral and the receivable.

The Company arranges secured financing by pledging securities owned and unpaid customer securities for short-term borrowings to satisfy margin deposits of clearing organizations. The Company also actively participates in the borrowing and lending of securities. In the event the counterparty in these and other securities loaned transactions is unable to return such securities pledged or borrowed or to repay the deposit placed with them, the Company may be exposed to the risks of acquiring the securities at prevailing market prices or holding collateral possessing a market value less than that of the related pledged securities. The Company seeks to control the risks by monitoring the market value of securities pledged and requiring adjustments of collateral levels where necessary.

#### **18. PREFERRED STOCK**

On October 17, 1997, the Company's Board of Directors ("Board") authorized 100,000 shares of preferred stock. Simultaneously, the Board designated 5,000 shares of the authorized preferred stock as Series A Preferred Stock. Up to 50 shares of the Series A Preferred Stock, which has a par value of \$20, can be issued to each of up to 100 qualified participants. Qualified participants are broker/dealers registered under the Act who clear their proprietary transactions through the Company and who represent that they are subject to net capital rules of the SEC and other self-regulatory organizations to which such broker/dealers report. The Series A Preferred Stock is nonvoting and nonconvertible to common stock, and it is entitled to noncumulative cash dividends when, as and if declared by the Board. The Series A Preferred Stock is redeemable at any time by the Company at a redemption price of \$1,000 per share.

#### **19. PAIB RESERVE REQUIREMENTS**

The Company performs calculations of the PAIB reserve requirements. At December 31, 2010, the Company did not have a PAIB reserve requirement and has no amount on deposit.



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