

Southwest Securities, Inc. (a subsidiary of SWS Group, Inc.)  
**STATEMENT OF FINANCIAL CONDITION**  
 June 29, 2007  
*(In thousands, except par, redemption values and share amounts)*

<b>Assets</b>	
Cash	\$ 4,550
Assets segregated for regulatory purposes	319,265
Receivable from brokers, dealers and clearing organizations	3,117,979
Receivable from clients	344,125
Securities owned, at market value	118,203
Securities purchased under agreements to resell	42,486
Fixed assets, at cost, less accumulated depreciation of \$27,524	8,283
Goodwill	7,552
Other assets (including \$928 from affiliates)	26,045
Total Assets	\$ 3,988,488

<b>Liabilities and Stockholders' Equity</b>	
Short-term borrowings	\$ 4,000
Payable to brokers, dealers and clearing organizations	3,060,817
Payable to clients	581,418
Drafts payable	25,718
Securities sold, not yet purchased, at market value	63,470
Securities sold under agreements to repurchase	17,829
Accrued expenses and other liabilities (including \$1,434 to affiliates)	42,611
	3,795,863

Stockholders' equity:	
Series A preferred stock, \$20 par value, \$1,000 redemption value; authorized 100,000 shares; issued and outstanding 50 shares	1
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	32,389
Retained earnings	160,232
	192,625
Total Liabilities and Stockholders' Equity	\$ 3,988,488

*See accompanying Notes to Statement of Financial Condition.*

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**Notes to Statement of Financial Condition**  
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*(In thousands, except par, redemption values and share amounts)*

**1. ORGANIZATION**

Southwest Securities, Inc. ("Company"), a 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 furniture, equipment and leasehold improvements which are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets (three to fourteen years). Additions, improvements and expenditures for repairs and maintenance that significantly extend the life of an asset are capitalized.

**Goodwill**

The Company accounts for goodwill under the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." The Company performed its annual assessment of the fair value of goodwill during fiscal 2007 as required by SFAS No. 142, and based on the results of the assessment, the Company's goodwill balance was not impaired.

**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 the Company's 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 statement of financial condition 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.

**Fair value of financial instruments**

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 are considered to be cash equivalents.

**4. ASSETS SEGREGATED FOR REGULATORY PURPOSES**

At June 29, 2007, the Company had cash and accrued interest of approximately \$319,265 segregated in special reserve bank accounts for the exclusive benefit of customers under Rule 15c3-3 pursuant to the Act.

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

At June 29, 2007, the Company had receivable from and payable to brokers, dealers and clearing organizations comprised of the following:

**Receivable**

Securities failed to deliver	\$ 26,786
Securities borrowed	2,987,906
Correspondent broker/dealers	33,943
Clearing organizations	12,853
Other	56,491
	<u>\$ 3,117,979</u>

**Payable**

Securities failed to receive	\$ 52,907
Securities loaned	2,961,001
Correspondent broker/dealers	25,254
Other	21,655
	<u>\$ 3,060,817</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. Settled 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.

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 had received collateral of approximately \$2,987,905 under securities lending agreements, of which the Company had repledged approximately \$2,939,853 at June 29, 2007.

Included in the receivable from brokers, dealers and clearing organizations is \$236 from affiliates. Included in the payable to brokers, dealers and clearing organizations is \$8,904 to affiliates.

**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 \$3,203 and \$512, respectively, at June 29, 2007. 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 June 29, 2007, the Company has approximately \$414,673 of client securities under customer margin loans that are available to be pledged, of which the Company has pledged approximately \$20,855 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 \$503,532 at June 29, 2007. During fiscal year 2007, the interest rates paid on these balances ranged from 3.9% to 4.2%. While the Company pays interest on these funds at varying rates, the rate paid at June 29, 2007 was 4.2%. The weighted average interest rate paid during fiscal 2007 was 4.1%.

The Company maintains an allowance for doubtful accounts of \$231 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 June 29, 2007, all unsecured customer receivables had been provided for in this allowance.

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

At June 29, 2007, securities owned and securities sold, not yet purchased, both of which are carried at market value, included the following:

**Securities owned:**

U.S. Government and Government agency obligations	\$	27,444
Municipal obligations		20,471
Corporate equity securities		16,377
Corporate obligations		45,391
Other		8,520
	\$	<u>118,203</u>

**Securities sold, not yet purchased:**

U.S. Government and Government agency obligations	\$	49,581
Corporate equity securities		1,070
Corporate obligations		12,726
Other		93
	\$	<u>63,470</u>

Certain of the above securities have been pledged to secure short-term borrowings or as security deposits at clearing organizations for the Company's clearing business. These pledged securities amounted to approximately \$4,130 at June 29, 2007.

The Company has been a member of the NYSE since 1972 owning one seat carried at a cost of \$230. Upon the merger of the NYSE and Archipelago Holdings, L.L.C. ("Archipelago") in March 2006, the Company surrendered its seat for the right to receive from the new entity, NYSE Euronext, Inc. ("NYSE Euro"), \$300 in cash and 80,177 restricted shares of NYSE Euro common stock (NYX), par value \$0.01 per share.

The Company also had an investment in 23,721 shares of Archipelago recorded at its cost of zero. Upon the merger, each outstanding share of Archipelago common stock was converted into one share of NYX stock.

Also, in lieu of a seat, the Company has an annual trading license. This license allows the Company continued physical and electronic access to the NYSE trading facilities following the close of the merger.

The 80,177 NYX shares received from the merger are restricted shares. These restrictions prohibit any "direct or indirect assignment, sale, exchange, transfer, tender or other disposition of NYX stock." The restrictions on the shares lapse based on a three year vesting schedule with restrictions lapsing on one-third of the restricted shares annually. The restriction on 26,727 shares of stock was lifted as of March 7, 2007. On June 7, 2007, NYSE Euro announced an early release of the restriction on an additional 26,725 shares. As of June 29, 2007, 26,725 shares are still restricted. There are no restrictions on the 23,721 shares from the investment in Archipelago upon conversion to NYX stock.

The remaining 26,725 NYX shares have been discounted at a rate of 21.9% of the market price of NYX stock at June 29, 2007. The discount rate was determined based on the length of time of the restrictions, expected rate of return for this type of investment and the relative amount of restricted NYX stock versus fully tradable stock.

As of June 29, 2007, our total investment, 103,898 of NYX shares, was valued at \$7,209.

**8. SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL**

Transactions involving purchases of securities under agreement to resell ("reverse repurchase agreements") are accounted for as collateralized financings except where the Company does not have an agreement to sell the same or substantially the same securities before maturity at a fixed or determinable price. At June 29, 2007, the Company held reverse repurchase agreements totaling

\$42,486, collateralized by U.S. Government and Government agency obligations with a market value of approximately \$42,572.

#### **9. INTANGIBLE ASSET**

On March 22, 2006, the Company entered into an agreement with TD Ameritrade Holding Corporation ("Ameritrade") to transfer 15 correspondent clients to the Company. This transaction closed in July 2006, with 12 of the 15 correspondents agreeing to transfer to the Company's clearing platform. The purchase price was based on the estimated value of the transferred correspondents. \$2,382 of the maximum agreed upon purchase price of \$5,800 was paid upon closing with the remainder to be paid on the one year anniversary of the closing date. Ameritrade received 78% of the remaining amount, \$2,678, in July 2007. As the agreed upon ticket volumes were not met, the second payment was pro-rated by the ticket volumes achieved compared to the agreed upon ticket volumes. As a result of this transaction, the Company has recorded a customer relationship intangible of \$5,060 at July 27, 2007. The amount of the intangible at June 29, 2007 was \$5,022. 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 intangible is included in Other Assets on the Statement of Financial Condition.

#### **10.SHORT-TERM BORROWINGS**

The Company has credit arrangements with commercial banks, which include broker loan lines up to \$275,000 at June 29, 2007 to finance securities owned, securities held for correspondent broker/dealer accounts, and receivables in customers' margin accounts. 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 (5.25% at June 29, 2007). At June 29, 2007, the amount outstanding under these secured arrangements was \$4,000, which was collateralized by securities held for firm accounts valued at \$38,849.

Additionally, the Company has an irrevocable letter of credit agreement aggregating \$48,000 at June 29, 2007, 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. The letter of credit is fully collateralized by marketable securities held in customers' and noncustomers' margin accounts with values of approximately \$66,381 at June 29, 2007.

The Company has unsecured letters of credit agreements aggregating \$250 at June 29, 2007, pledged to support its open positions with securities clearing organizations. The unsecured letters of credit bear a 1% commitment fee and are renewable semi-annually.

In addition, the Company has an unsecured line of credit aggregating \$10,000 that is due on demand and bears interest at rates indexed to the federal funds rate. The total amount of borrowings available under this line of credit is reduced by the amount outstanding on the line and under the unsecured letters of credit at the time of borrowing. At June 29, 2007, the total amount available for borrowings was \$9,750. There were no amounts outstanding on this unsecured line of credit other than \$250 under unsecured letters of credit at June 29, 2007.

#### **11. 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 June 29, 2007 was \$17,829.

#### **12.INCOME TAXES**

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at June 29, 2007 are presented below:

<b>Deferred tax assets</b>	
Accrued expenses	\$ 3,029
Fixed assets	73
Other	<u>776</u>
Total gross deferred tax asset	<u>3,878</u>
<b>Deferred tax liabilities</b>	
Net deferred tax asset included in other assets	<u>(463)</u>
	<u>\$ 3,415</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 receivable at June 29, 2007 was \$1,014.

### 13.NET CAPITAL REQUIREMENTS

The Company is subject to the Securities Exchange Commission's Uniform Net Capital 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 pursuant to the Act, equal to the greater of \$1,000 or 2% of aggregate debit balances, as defined in Rule 15c3-3 pursuant to the Act. At June 29, 2007, the Company had net capital of approximately \$133,002, which is approximately \$124,195 in excess of its minimum net capital requirement of approximately \$8,807 at that date. Additionally, Rule 15c3-1 provides that equity may not be withdrawn or cash dividends paid if resulting net capital would be less than 5% of aggregate debit items. At June 29, 2007, the Company had net capital of approximately \$110,986 in excess of 5% of aggregate debit items.

### 14.AFFILIATE TRANSACTIONS

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

### 15.COMMITMENTS AND CONTINGENCIES

The Company leases its offices and certain equipment under noncancelable operating lease agreements. At June 29, 2007 the future rental payments for the noncancelable leases for each of the following five fiscal years and thereafter follows:

2008	\$ 2,952
2009	2,464
2010	1,691
2011	1,293
2012	785
Thereafter	<u>858</u>
	<u>\$ 10,043</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. Total liabilities on open underwritings at June 29, 2007 were \$389. Open underwritings are generally scheduled to be

settled within the next 60 days and are expected to have no material adverse effect on the Company's financial position.

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 \$532 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.

#### **16.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 at 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 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.

#### **17. 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.

#### **18. PAIB RESERVE REQUIREMENTS**

The Company performs calculations of Proprietary Accounts of Introducing Brokers ("PAIB") reserve requirements. At June 29, 2007, the Company did not have a PAIB reserve requirement and has no amount on deposit.



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