

Southwest Securities, Inc. (a subsidiary of SWS Group, Inc.)
STATEMENT OF FINANCIAL CONDITION
December 31, 2008
(In thousands, except par, redemption values and share amounts)
(unaudited)

Assets	
Cash	\$ 48,972
Assets segregated for regulatory purposes	255,150
Receivable from brokers, dealers and clearing organizations	2,173,843
Receivable from clients	193,765
Securities owned, at market value	107,650
Securities purchased under agreements to resell	4,415
Fixed assets, at cost, less accumulated depreciation of \$28,384	10,645
Goodwill	7,552
Intangible, net of accumulated amortization of \$2,761	2,299
Other assets (including \$17,338 from affiliates)	42,961
Total Assets	\$ 2,847,252

Liabilities and Stockholders' Equity	
Payable to brokers, dealers and clearing organizations	\$ 2,087,970
Payable to clients	448,714
Drafts payable	23,506
Securities sold, not yet purchased, at market value	23,360
Securities sold under agreements to repurchase	3,646
Accrued expenses and other liabilities (including \$1,096 to affiliates)	44,127
	2,631,323

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	183,586
	215,929
Total liabilities and stockholder's equity	\$ 2,847,252

See accompanying Notes to Statement of Financial Condition.

Southwest Securities, Inc. (a subsidiary of SWS Group, Inc.)
Notes to Statement of Financial Condition
December 31, 2008
(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.

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 2008 as required by SFAS No. 142, and based on the results of the assessment, the goodwill balance was not impaired. The Company bases its assessment of the fair value of the business units with goodwill on a weighted average of a discounted cash flow model estimate of fair value and market multiple approach to fair value. No events occurred in the first six-months of fiscal 2009 that indicated that this assessment should be tested for impairment as the business units of the Company continued to report pre-tax income for the six-month period ended December 31, 2008. Also, the consolidated entity, SWS Group, Inc., had income in the six-months ended December 31, 2008 and the stock price at the end of December 2008 was above its book value per share of \$12.21. Goodwill is valued at \$7,552.

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 financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. 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.

In July 2006, the Financial Accounting Standard's Board ("FASB") issued FASB Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes-an Interpretation of FASB statement 109,"* ("FIN 48") with respect to all income tax positions accounted for under FASB Statement 109, *"Accounting for Income Taxes."* The interpretation addresses the recognition, measurement, accrual of interest and penalties, balance sheet classification and disclosure of any uncertain tax positions. The Company adopted the provisions of FIN 48 beginning in fiscal 2008.

At December 31, 2008, the Company had approximately \$1,132 of unrecognized tax benefits. The net liability decreased \$145 from June 27, 2008 to December 31, 2008 as the statute of limitations expired on previously 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 is accrued interest and penalties of \$139, net of federal benefit as of December 31, 2008. The total amount of unrecognized income tax benefits that, if recognized, would reduce income tax expense is approximately \$993, net of federal benefit as of December 31, 2008.

With limited exception, the Company is no longer subject to U.S. Federal or state income tax examinations by taxing authorities for years preceding 2004. Federal income tax returns for the years ended December 31, 2004 through 2007 are currently under examination by the Internal Revenue Service.

Fair value of financial instruments

The Company adopted FASB Statement of Financial Accounting Standards ("SFAS") No. 157, effective June 28, 2008, with the exception of non-financial assets and liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), which was delayed by FASB Staff Position No. FAS 157-2. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements.

Under the standard, 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 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 certain inventories held in our 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 our securities owned and securities sold, not yet purchased portfolio. These financial instruments are valued by 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 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 our securities owned and securities sold, not yet purchased 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 balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Securities Owned and Securities Sold, Not Yet Purchased Portfolio. 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.

Level 2 includes 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.

Level 3 is comprised of securities whose fair value is estimated based on internally developed models or methodologies utilizing significant inputs that are generally less readily observable. Included in this category are certain corporate equity securities and corporate and municipal debt.

The following table summarizes by level within the fair value hierarchy “Securities owned, at market value” and “Securities sold, not yet purchased, at market value” as of December 31, 2008.

(in thousands)

	Level 1	Level 2	Level 3	Total
Securities owned, at market value				
Corporate equity securities	\$ 1,771	\$ —	\$ 925	\$ 2,696
Municipal obligations	—	48,570	24,475	73,045
U.S. government agency obligations	5,333	5,241	—	10,574
Corporate obligations	—	20,081	267	20,348
Other	—	987	—	987
	<u>\$ 7,104</u>	<u>\$ 74,879</u>	<u>\$ 25,667</u>	<u>\$ 107,650</u>
Securities sold, not yet purchased, at market value				
Corporate equity securities	\$ 687	\$ —	\$ —	\$ 687
Municipal obligations	—	30	—	30
U.S. government and government agency obligations	5,862	6,953	—	12,815
Corporate obligations	—	8,928	—	8,928
Other	—	900	—	900
	<u>\$ 6,549</u>	<u>\$ 16,811</u>	<u>\$ —</u>	<u>\$ 23,360</u>

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

(in thousands)	Corporate Equity Securities	Municipal Obligations	Corporate Obligations	Total
Beginning balance at June 28, 2008	\$ 1,175	\$ 46,400	\$ 3,424	\$ 50,999
Unrealized gains (losses)	—	—	(50)	(50)
Realized gains (losses)	—	—	(1,010)	(1,010)
Purchases, issuances, and settlements	(250)	17,400	(2,290)	14,860
Ending balance at September 26, 2008	<u>\$ 925</u>	<u>\$ 63,800</u>	<u>\$ 74</u>	<u>\$ 64,799</u>
Unrealized gains (losses)	—	—	193	193
Realized gains (losses)	—	—	—	—
Transfers out of Level 3	—	(14,950)	—	(14,950)
Purchases, issuances, and settlements	—	(24,375)	—	(24,375)
Ending balance at December 31, 2008	<u>\$ 925</u>	<u>\$ 24,475</u>	<u>\$ 267</u>	<u>\$ 25,667</u>

The total unrealized gains for the three and six-month periods ended December 31, 2008 included in earnings that relate to assets still held at December 31, 2008 were \$193,000 and \$143,000, respectively.

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 bank accounts. In addition, the Company considers funds due from banks and interest bearing deposit in other banks to be cash. Highly liquid debt instruments purchased with original maturities of three months or less, when acquired, are considered to be cash equivalents.

4. ASSETS SEGREGATED FOR REGULATORY PURPOSES

At December 31, 2008, the Company had cash of approximately \$255,150 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 December 31, 2008, the Company had receivable from and payable to brokers, dealers and clearing organizations related to the following:

Receivable

Securities failed to deliver	\$ 33,967
Securities borrowed	2,089,001
Correspondent broker/dealers	24,190
Clearing organizations	13,110
Other	13,575
	<u>\$ 2,173,843</u>

Payable

Securities failed to receive	\$ 13,348
Securities loaned	2,050,536
Correspondent broker/dealers	14,091
Other	9,995
	<u>\$ 2,087,970</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 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.

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. The Company had received collateral of approximately \$2,087,854 under securities lending agreements, of which the Company had repledged approximately \$2,046,174 at December 31, 2008.

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 \$3,152 and \$1,185, respectively, at December 31, 2008. 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, 2008, the Company has approximately \$238,393 of client securities under customer margin loans that are available to be pledged, of which the Company has pledged approximately \$4,052 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 \$382,784 at December 31, 2008. During fiscal year 2009, the interest rates paid on these balances ranged from 0.2% to 1.3%. While the Company pays interest on these funds at varying rates, the rate paid at December 31, 2008 was 0.3%. The weighted average interest rate paid during fiscal 2009 was 0.9%.

The Company maintains an allowance for doubtful accounts of \$1,232 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, 2008, all unsecured customer receivables had been provided for in this allowance.

7. SECURITIES OWNED AND SECURITIES SOLD, NOT YET PURCHASED

At December 31, 2008, 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	\$ 10,574
Municipal obligations	73,045
Corporate equity securities	2,696
Corporate obligations	20,348
Other	987
	<u>\$ 107,650</u>

Securities sold, not yet purchased:

U.S. government and government agency obligations	\$ 12,815
Municipal obligations	30
Corporate equity securities	687
Corporate obligations	8,928
Other	900
	<u>\$ 23,360</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 \$4,399 at December 31, 2008.

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 December 31, 2008, the Company held reverse repurchase agreements totaling \$4,415, collateralized by U.S. government and government agency obligations with a market value of approximately \$4,349.

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 volume. As a result of these transactions, the Company has recorded a customer relationship intangible of \$5,060 at December 31, 2008. The amount of the intangible, net of accumulated

amortization at December 31, 2008 was \$2,299. 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. No events occurred in the first six-months of fiscal 2009 that indicated that this asset should be tested for impairment.

10.SHORT-TERM BORROWINGS

The Company has credit arrangements with commercial banks, which include broker loan lines up to \$275,000 at December 31, 2008. The Company has not received any notification from the bank indicating a change in the amount of the broker loan lines since June 2008. These lines of credit are used primarily 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 (0.25 at December 31, 2008). At December 31, 2008, there were no amounts outstanding under these secured arrangements.

Additionally, the Company has an irrevocable letter of credit agreement aggregating \$50,000 at December 31, 2008, 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 \$82,114 at December 31, 2008.

The Company has unsecured letters of credit agreements aggregating \$250 at December 31, 2008, 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. 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 the unsecured letters of credit at the time of borrowing. There was no amount outstanding on this unsecured line of credit other than the \$250 under unsecured letters of credit at December 31, 2008. At December 31, 2008, the total amount available for borrowing was \$9,750.

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 December 31, 2008 were \$3,646.

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 December 31, 2008 are presented below:

Deferred tax assets:

Accrued expenses	\$ 5,983
Other	1,304
Total gross deferred tax asset	<u>7,287</u>

Deferred tax liabilities:

Fixed assets	<u>(1,123)</u>
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Net deferred tax asset included in other assets	\$ 6,164
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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, 2008 was \$5,011.

13.NET CAPITAL REQUIREMENTS

The Company is subject to the Securities 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 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 December 31, 2008, the Company had net capital of approximately \$125,559 which is approximately \$119,796 in excess of its minimum net capital requirement of approximately \$5,763 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, 2008, the Company had net capital of approximately \$111,151 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 all accounting, administrative services, 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 December 31, 2008 the future rental payments for the noncancelable operating leases for each of the following five fiscal years and thereafter follows:

2009	\$ 5,115
2010	4,247
2011	3,660
2012	3,011
2013	2,340
Thereafter	2,640
	\$ 21,013

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 open commitments for underwritings at December 31, 2008.

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 \$1,137 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 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.

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 December 31, 2008, the Company did not have a PAIB reserve requirement and has no amount on deposit.



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