

Southwest Securities, Inc. (a subsidiary of SWS Group, Inc.)  
**STATEMENT OF FINANCIAL CONDITION**  
December 31, 2007  
*(In thousands, except par, redemption values and share amounts)*  
*(Unaudited)*

<b>Assets</b>	
Cash	\$ 18,381
Assets segregated for regulatory purposes	302,565
Receivable from brokers, dealers and clearing organizations	2,842,621
Receivable from clients	363,473
Securities owned, at market value	88,961
Securities purchased under agreements to resell	14,098
Fixed assets, at cost, less accumulated depreciation of \$26,779	9,400
Goodwill	7,552
Other assets (including \$2,547 from affiliates)	26,929
Total Assets	\$ 3,673,980

<b>Liabilities and Stockholders' Equity</b>	
Payable to brokers, dealers and clearing organizations	\$ 2,778,348
Payable to clients	592,344
Drafts payable	27,143
Securities sold, not yet purchased, at market value	41,554
Securities sold under agreements to repurchase	3,673
Accrued expenses and other liabilities (including \$2,173 to affiliates)	42,025
	3,485,087

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	156,500
	188,893
Total Liabilities and Stockholders' Equity	\$ 3,673,980

*See accompanying Notes to Statement of Financial Condition.*

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**Notes to Statement of Financial Condition**  
December 31, 2007  
*(In thousands, except par, redemption values and share amounts)*  
*(Unaudited)*

**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 (the "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 December 31, 2007, the Company had cash of approximately \$302,565 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, 2007, the Company had receivable from and payable to brokers, dealers and clearing organizations comprised of the following:

#### **Receivable**

Securities failed to deliver	\$ 36,236
Securities borrowed	2,727,083
Correspondent broker/dealers	24,774
Clearing organizations	9,647
Other	44,881
	<u>\$ 2,842,621</u>

**Payable**

Securities failed to receive	\$ 54,754
Securities loaned	2,692,179
Correspondent broker/dealers	17,526
Other	13,889
	<u>\$ 2,778,348</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 \$2,727,066 under securities lending agreements, of which the Company had repledged approximately \$2,670,483 at December 31, 2007.

**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 \$1,688 and \$501, respectively, at December 31, 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 December 31, 2007, the Company has approximately \$456,227 of client securities under customer margin loans that are available to be pledged, of which the Company has pledged approximately \$21,533 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 \$510,663 at December 31, 2007. During the first half of fiscal year 2007, the interest rates paid on these balances ranged from 3.65% to 4.15%. While the Company pays interest on these funds at varying rates, the rate paid at December 31, 2007 was 3.65%. The weighted average interest rate paid for the first half of fiscal 2007 was 4.0%.

The Company maintains an allowance for doubtful accounts of \$536 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, 2007, all unsecured customer receivables had been provided for in this allowance.

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

At December 31, 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	\$	15,089
Municipal obligations		21,681
Corporate equity securities		6,236
Corporate obligations		42,742
Other		3,213
	\$	<u>88,961</u>

### Securities sold, not yet purchased:

U.S. Government and Government agency obligations	\$	28,433
Municipal obligations		49
Corporate equity securities		848
Corporate obligations		12,122
Other		102
	\$	<u>41,554</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 \$5,048 at December 31, 2007. Additionally, at December 31, 2007, the Company had pledged firm securities valued at \$76 in conjunction with securities lending activities.

## 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, 2007, the Company held reverse repurchase agreements totaling \$14,098, collateralized by U.S. Government and Government agency obligations with a market value of approximately \$14,111.

## 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 December 31, 2007. 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 December 31, 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 (4.25% at December 31, 2007). At December 31, 2007, there were no amounts outstanding under these secured arrangements.

Additionally, the Company has an irrevocable letter of credit agreement aggregating \$46,000 at December 31, 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 \$80,095 at December 31, 2007.

The Company has unsecured letters of credit agreements aggregating \$250 at December 31, 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 December 31, 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 December 31, 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 December 31, 2007 were \$3,673.

#### **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, 2007 are presented below:

##### **Deferred tax assets**

Accrued expenses	\$ 4,764
State deferred taxes	415
Other	<u>638</u>
Total gross deferred tax asset	<u>5,817</u>

##### **Deferred tax liabilities**

Fixed assets	(577)
Other	<u>(58)</u>
Total gross deferred tax liabilities	<u>(635)</u>
Net deferred tax asset included in other assets	<u>\$ 5,182</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, 2007 was \$5,768.

#### **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 December 31, 2007, the Company had net capital of approximately \$129,538, which is approximately \$120,380 in excess of its minimum net capital requirement of approximately \$9,158 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 December 31, 2007, the Company had net capital of approximately \$106,642 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 December 31, 2007 the future rental payments for the noncancelable leases for each of the following five fiscal years and thereafter follows:

2008	\$ 2,863
2009	2,372
2010	1,732
2011	1,282
2012	938
Thereafter	<u>562</u>
	<u>\$ 9,749</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. 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. There were no open underwritings at December 31, 2007.

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 \$593 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 December 31, 2007, the Company did not have a PAIB reserve requirement and has no amount on deposit.

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