LPL Investment Holdings Inc.
Form 10-Q
November 14, 2007

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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended September 30, 2007**

**or**

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

**For the transition period from to**
**Commission File Number: 000-52609**

# LPL Investment Holdings Inc.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **20-3717839** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**One Beacon Street, Floor 22**
**Boston MA 02108**
**(617) 423-3644**

(Address including zip code, and telephone number, including area code, of principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. o Yes ý No

Indicate by check mark whether the registrant is a large accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer ý

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes ý No

The number of shares of Common Stock, par value $0.01 per share, outstanding as of September 30, 2007 was 8,620,294.19.

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**Where You Can Find More Information**

We are required to file annual, quarterly and current reports, proxy statements and other information required by the Securities Exchange Act of 1934, as amended, with the Securities and Exchange Commission, or SEC. You may read and copy any document we file with the SEC at the SEC's public reference room located at 100 F Street, N.E., Washington, D.C. 20549, U.S.A. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public from the SEC's internet site at http://www.sec.gov.

*When we use the terms "LPLIH", "we", "us", "our", and the "firm" we mean LPL Investment Holdings Inc., a Delaware corporation, and its consolidated subsidiaries, taken as a whole, as well as any predecessor entities, unless the context otherwise indicates.*

**Special Note Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q in Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in other sections includes forward-looking statements. In some cases, you can identify these statements by forward-looking words such as "may", "might", "will", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "intend" or "continue", the negative of these terms and other comparable terminology. These forward-looking statements, which are subject to risks, uncertainties and assumptions about us, may include expectations as to our future financial performance, which in some cases may be based on our growth strategies and anticipated trends in our business. These statements are based on our current expectations and projections about future events. There are important factors that could cause our actual results, level of activity, performance or achievements to differ materially from the results, level of activity, performance or achievements expressed or implied by the forward-looking statements. In particular, you should consider the numerous risks outlined in Part I, Item 1A "Risk Factors" in the Form 10-A filed by the Company on July 31, 2007.

Although we believe the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, level of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy or completeness of any of these forward-looking statements. You should not rely upon forward-looking statements as predictions of future events. We are under no duty to update any of these forward-looking statements after the date of this filing to conform our prior forward-looking statements to actual results or revised expectations.

**PART I FINANCIAL INFORMATION**

**Item 1. Unaudited Consolidated Financial Statements.**

**LPL INVESTMENT HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

**AS OF SEPTEMBER 30, 2007 (UNAUDITED) AND DECEMBER 31, 2006**

**(Dollars in thousands, except par value)**

| | 2007 | 2006 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 259,117 | $ 245,163 |
| Cash and securities segregated under federal and other regulations | 87,555 | 52,178 |
| Receivable from: | | |
| Customers, net of allowance of $502 at September 30, 2007 and $202 at December 31, 2006 | 383,431 | 326,376 |
| Product sponsors, broker-dealers, and clearing organizations | 129,581 | 89,706 |
| Others, net of allowances of $2,977 at September 30, 2007 and $2,590 at December 31, 2006 | 82,285 | 52,088 |
| Securities owned: | | |
| Marketable securities(1) at market value | 16,003 | 9,524 |
| Other securities at amortized cost | 8,919 | 10,635 |
| Securities borrowed | 7,344 | 12,686 |
| Mortgage loans held for sale net | 3,719 | 4,362 |
| Fixed assets, net of accumulated depreciation and amortization of $123,804 at September 30, 2007 and $90,731 at December 31, 2006 | 141,679 | 121,594 |
| Debt issuance costs, net of accumulated amortization of $7,303 at September 30, 2007 and $4,564 at December 31, 2006 | 24,605 | 26,469 |
| Goodwill | 1,289,307 | 1,249,159 |
| Intangible assets, net of accumulated amortization of $56,273 at September 30, 2007 and $31,245 at December 31, 2006 | 635,789 | 535,289 |
| Trademarks and trade names, net of accumulated amortization of $379 at September 30, 2007 and $0 at December 31, 2006 | 42,197 | 39,819 |
| Interest rate swaps | | 3,188 |
| Prepaid expenses | 14,241 | 15,423 |
| Other assets | 23,784 | 3,885 |
| Total assets | $ 3,149,556 | $ 2,797,544 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| LIABILITIES: | | |
| Warehouse lines of credit | $ 1,769 | $ 3,718 |
| Bank loans payable | 16,000 | |
| Drafts payable | 129,414 | 104,344 |
| Payable to customers | 327,622 | 294,574 |
| Payable to broker-dealers and clearing organizations | 58,875 | 30,354 |
| Accrued commissions and advisory fees payable | 113,615 | 70,096 |
| Accounts payable and accrued liabilities | 101,433 | 34,381 |
| Income taxes payable | 686 | 969 |
| Unearned revenue | 35,017 | 31,113 |
| Interest rate swaps | 2,068 | |
| Securities sold but not yet purchased at market value | 4,924 | 10,806 |
| Senior credit facilities and subordinated notes | 1,388,177 | 1,344,375 |
| Deferred income taxes net | 226,830 | 245,897 |
| Total liabilities | 2,406,430 | 2,170,627 |
| COMMITMENTS AND CONTINGENCIES (Note 15) | | |
| STOCKHOLDERS' EQUITY: | | |

| | 2007 | 2006 |
|---|---|---|
| Common stock, $.01 par value; 20,000,000 shares authorized; 8,620,294 shares issued and outstanding at September 30, 2007, and 8,284,360 shares issued and outstanding at December 31, 2006 | 86 | 83 |
| Additional paid-in capital | 663,664 | 591,254 |
| Stockholder loans | (1,877) | |
| Accumulated other comprehensive (loss) income, net of income taxes | (1,257) | 1,938 |
| Retained earnings | 82,510 | 33,642 |
| Total stockholders' equity | 743,126 | 626,917 |
| Total liabilities and stockholders' equity | $ 3,149,556 | $ 2,797,544 |

(1) Includes $2,684 and $2,643 pledged to clearing organizations at September 30, 2007 and December 31, 2006, respectively.

See notes to unaudited consolidated financial statements.

**LPL INVESTMENT HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006**

**(UNAUDITED) (Dollars in thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| REVENUES: | | | | |
| Commissions | $ 386,339 | $ 205,746 | $ 1,050,071 | $ 650,448 |
| Advisory fees | 201,302 | 133,544 | 526,879 | 380,653 |
| Asset-based fees | 71,337 | 34,112 | 180,125 | 99,374 |
| Transaction and other fees | 49,508 | 37,476 | 131,185 | 106,560 |
| Interest income | 9,582 | 7,443 | 26,235 | 20,003 |
| Other | 6,949 | 2,524 | 21,124 | 8,233 |
| Total revenues | 725,017 | 420,845 | 1,935,619 | 1,265,271 |
| EXPENSES: | | | | |
| Commissions and advisory fees | 510,886 | 291,521 | 1,358,868 | 884,283 |
| Compensation and benefits | 71,448 | 34,527 | 171,034 | 99,190 |
| Depreciation and amortization | 20,643 | 16,399 | 56,801 | 48,815 |
| Promotional | 28,387 | 14,062 | 49,916 | 29,847 |
| Occupancy and equipment | 11,604 | 6,785 | 29,074 | 18,952 |
| Communications and data processing | 6,971 | 4,755 | 18,511 | 15,980 |
| Brokerage, clearing, and exchange | 7,603 | 4,620 | 19,122 | 12,790 |
| Professional services | 5,752 | 3,172 | 16,882 | 8,663 |
| Regulatory fees and expenses | 4,907 | 3,314 | 12,613 | 12,032 |
| Travel and entertainment | 3,833 | 1,733 | 9,469 | 4,743 |
| Other | 3,731 | 124 | 8,140 | 2,926 |
| Total noninterest expenses | 675,765 | 381,012 | 1,750,430 | 1,138,221 |
| Interest expense from brokerage operations and mortgage lending | 183 | 52 | 463 | 248 |
| Interest expense from senior credit facilities and subordinated notes | 30,857 | 31,103 | 92,340 | 94,292 |
| Total expenses | 706,805 | 412,167 | 1,843,233 | 1,232,761 |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 18,212 | 8,678 | 92,386 | 32,510 |
| PROVISION FOR INCOME TAXES | 6,645 | 3,472 | 39,073 | 12,148 |
| NET INCOME | $ 11,567 | $ 5,206 | $ 53,313 | $ 20,362 |

See notes to unaudited consolidated financial statements.

**LPL INVESTMENT HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006**

**(UNAUDITED) (Dollars in thousands)**

| | Common Stock | Additional Paid-In Capital | Stockholder Loans | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Total Stockholders' Equity |
|---|---|---|---|---|---|---|
| BALANCE December 31, 2005 | $ 83 | $ 588,341 | $ | $ | $ | $ 588,424 |
| Comprehensive income: | | | | | | |
| Net income | | | | | 20,362 | 20,362 |
| Change in unrealized gains on interest rate swaps, net of tax expense of $1,116 (Note 13) | | | | 1,680 | | 1,680 |
| Total comprehensive income | | | | | | 22,042 |
| Share-based compensation | | 2,144 | | | | 2,144 |
| BALANCE September 30, 2006 | $ 83 | $ 590,485 | $ | $ 1,680 | $ 20,362 | $ 612,610 |
| BALANCE December 31, 2006 | $ 83 | $ 591,254 | $ | $ 1,938 | $ 33,642 | $ 626,917 |
| Comprehensive income: | | | | | | |
| Net income | | | | | 53,313 | 53,313 |
| Change in unrealized losses on interest rate swaps, net of tax benefit of $2,061 (Note 13) | | | | (3,195) | | (3,195) |
| Total comprehensive income | | | | | | 50,118 |
| Cumulative effect of change in accounting principle upon adoption of FIN 48, net of tax benefit of $2,101 (Note 11) | | | | | (4,445) | (4,445) |
| Loans to stockholders (Note 18) | | | (1,877) | | | (1,877) |
| Share-based compensation | | 1,499 | | | | 1,499 |
| Issuance of common stock for acquisitions (Note 3) | 3 | 70,911 | | | | 70,914 |
| BALANCE September 30, 2007 | $ 86 | $ 663,664 | $ (1,877) | $ (1,257) | $ 82,510 | $ 743,126 |

See notes to unaudited consolidated financial statements.

**LPL INVESTMENT HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006**

**(UNAUDITED) (Dollars in thousands)**

| | 2007 | 2006 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 53,313 | $ 20,362 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Noncash items: | | |
| Depreciation and amortization | 56,801 | 48,815 |
| Amortization of debt issuance costs | 2,739 | 3,637 |
| Loss (gain) on disposal of fixed assets | 136 | (9) |
| Share-based compensation | 1,499 | 2,144 |
| Provision for bad debts | 698 | 677 |
| Deferred income tax provision | (14,905) | (13,277) |
| Other | 165 | (333) |
| Mortgage loans held for sale: | | |
| Originations of loans | (97,732) | (49,887) |
| Proceeds from sale of loans | 99,374 | 47,232 |
| Gain on sale | (978) | (760) |
| Changes in operating assets and liabilities: | | |
| Cash and securities segregated under federal and other regulations | (35,377) | 10,833 |
| Receivable from customers | (57,355) | (54,809) |
| Receivable from product sponsors, broker-dealers, and clearing organizations | (27,910) | 21,350 |
| Receivable from others | (24,599) | (5,959) |
| Securities owned | (4,563) | (4,259) |
| Securities borrowed | 5,342 | (2,175) |
| Prepaid expenses | 2,721 | 2,734 |
| Other assets | 4,938 | 257 |
| Drafts payable | 24,527 | 2,556 |
| Payable to customers | 33,048 | 17,398 |
| Payable to broker-dealers and clearing organizations | 28,520 | 9,243 |
| Accrued commissions and advisory fees payable | 17,216 | 9,340 |
| Accounts payable and accrued liabilities | 37,236 | 3,121 |
| Income taxes payable/receivable | (7,420) | 41,871 |
| Unearned revenue | 2,553 | 1,230 |
| Securities sold but not yet purchased | (5,882) | (2,707) |
| Net cash provided by operating activities | 94,105 | 108,625 |

See notes to unaudited consolidated financial statements.

| | 2007 | 2006 |
|---|---|---|
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Acquisitions, net of existing cash balances of $52,215 | $ (88,515) | |
| Capital expenditures | (40,520) | $ (12,900) |
| Proceeds from disposal of fixed assets | 41 | 9 |
| Purchase of other securities classified as held-to-maturity | (2,204) | (34,020) |
| Proceeds from maturity of other securities classified as held-to-maturity | 4,004 | 26,999 |
| Purchase of equity investment | (5,000) | |
| Purchase of intangible assets | (2,997) | |
| Net cash used in investing activities | (135,191) | (19,912) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from bank loans | 16,000 | |
| Repayment of senior credit facilities | (6,198) | (50,625) |
| Proceeds from senior credit facilities | 50,000 | |
| Payment of debt issuance costs | (936) | |
| Loans to stockholders | (1,877) | |
| Proceeds from warehouse lines of credit | 97,736 | 49,872 |
| Repayment of warehouse lines of credit | (99,685) | (46,472) |
| Net cash provided by (used in) financing activities | 55,040 | (47,225) |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 13,954 | 41,488 |
| CASH AND CASH EQUIVALENTS Beginning of period | 245,163 | 134,592 |
| CASH AND CASH EQUIVALENTS End of period | $ 259,117 | $ 176,080 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Interest paid | $ 78,174 | $ 77,941 |
| Income taxes paid (refunded) | $ 58,121 | $ (17,234) |
| NONCASH DISCLOSURE: | | |
| Income taxes payable recorded as a cumulative effect of change in accounting principle upon the adoption of FIN 48 (Note 11) | $ (6,546) | |
| Capital expenditures purchased through short-term credit | $ 4,084 | |
| Acquisitions: | | |
| Fair value of assets acquired | $ 265,240 | |
| Cash paid for common stock acquired | (140,730) | |
| Common stock issued for acquisitions | 68,552 | |
| Liabilities assumed (Note 3) | $ 55,958 | |
| Common stock issued to acquire intangible assets | $ 1,118 | |
| Common stock issued to satisfy accrued liability (Note 3) | $ 1,244 | |

See notes to unaudited consolidated financial statements.

**LPL INVESTMENT HOLDINGS INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

## 1. ORGANIZATION AND DESCRIPTION OF THE COMPANY

LPL Investment Holdings Inc. ("LPLIH"), a Delaware holding corporation, together with its consolidated subsidiaries (collectively, the "Company") is a provider of brokerage, investment advisory, and infrastructure services to independent financial advisors ("IFAs") and financial institutions who employ financial advisors ("FAs"), in the United States of America. The Company provides access to a broad array of financial products and services for IFAs and financial institutions who employ financial advisors, to market to their clients, as well as a technology and service platform to enable IFAs to more efficiently operate their practices.

On December 28, 2005, LPL Holdings, Inc. ("LPLH"), a Massachusetts holding corporation, and its subsidiaries were acquired through a merger transaction with BD Acquisition Inc., a wholly owned subsidiary of LPLIH (previously named BD Investment Holdings, Inc.). LPLIH was formed by investment funds affiliated with TPG Partners IV, L.P., and Hellman & Friedman Capital Partners V, L.P. (collectively, the "Majority Holders"). The acquisition was accomplished through the merger of BD Acquisition, Inc. with and into LPLH, with LPLH being the surviving entity (the "Acquisition"). The Acquisition was financed by a combination of borrowings under the Company's new senior credit facilities, the issuance of senior unsecured subordinated notes, and direct and indirect equity investments from the Majority Holders, co-investors, management, and the Company's IFAs.

On January 2, 2007, the Company acquired all of the outstanding capital stock of UVEST Financial Services Group, Inc. ("UVEST"). In accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, *Business Combinations* ("SFAS 141"), the acquisition has been accounted for under the purchase method of accounting. As a result, the accompanying consolidated financial statements and these notes include the balances of UVEST as of September 30, 2007, and the results of its operations, cash flows, and other activities for the period January 2, 2007 through September 30, 2007 (see Note 3).

On June 20, 2007, the Company acquired from Pacific Life Insurance Company all the outstanding membership interests of Pacific Select Group, LLC and its wholly owned subsidiaries Mutual Service Corporation ("MSC"), Associated Financial Group, Inc. ("AFG"), and Waterstone Financial Group, Inc. ("WFG"). In connection with the acquisition, Pacific Select Group, LLC changed its name to LPL Independent Advisor Services Group LLC ("IASG"). In accordance with SFAS 141, the acquisition has been accounted for under the purchase method of accounting. As a result, the accompanying consolidated financial statements and these notes include the balances of IASG as of September 30, 2007, and the results of its operations, cash flows, and other activities for the period June 20, 2007 through September 30, 2007 (see Note 3).

***Description of Our Subsidiaries*** LPLH, a Massachusetts holding corporation, owns 100% of the issued and outstanding common stock of Linsco/Private Ledger Corp. ("Linsco"), UVEST, IASG, Independent Advisers Group Corporation ("IAG"), Innovex Mortgage, Inc. ("Innovex"), and Linsco/Private Ledger Insurance Associates, Inc. ("LPL Insurance Associates"). LPLH is also the majority stockholder in Private Trust Company Holdings, Inc. ("PTCH"), and owns 100% of the issued and outstanding voting common stock. As required by the Office of the Comptroller of the Currency, members of the Board of Directors of PTCH own eight shares of nonvoting common stock in PTCH.

Linsco, headquartered in Boston and San Diego, is a clearing broker-dealer registered with the Financial Industry Regulatory Authority ("FINRA") and the Securities and Exchange Commission ("SEC") pursuant to the Securities Exchange Act of 1934 and an investment adviser registered with the

SEC pursuant to the Investment Advisers Act of 1940. Linsco is also registered as a Futures Commission Merchant with the Commodity Futures Trading Commission ("CFTC") and is a member of the National Futures Association. Additionally, Linsco is a member of the Boston Stock Exchange.

Linsco principally transacts business as an agent for IFAs and FAs on behalf of customers in mutual funds, stocks, fixed income instruments, commodities, options, private and public partnerships, variable annuities, real estate investment trusts, and other investment products. Linsco is licensed to operate in all 50 states and Puerto Rico and has an independent contractor sales force of approximately 7,800 registered IFAs dispersed throughout the United States.

UVEST, a North Carolina corporation, is an introducing broker-dealer registered with the FINRA and the SEC pursuant to the Securities Exchange Act of 1934 and an investment adviser registered with the SEC pursuant to the Investment Advisers Act of 1940. UVEST provides independent, nonproprietary third-party brokerage services to more than 300 financial institutions. UVEST is licensed to operate in all 50 states and Puerto Rico and has a sales force of approximately 800 registered FAs disbursed throughout the United States.

IASG, a Delaware limited liability company, is a holding company for MSC, AFG, and WFG. MSC, a Michigan corporation, is an introducing broker-dealer registered with the SEC and the FINRA. Contemporary Financial Solutions, Inc., a Delaware corporation, is an introducing broker-dealer and a wholly owned subsidiary of MSC. AFG, a California corporation, is a holding company of wholly owned subsidiaries; Associated Securities Corp., an introducing broker-dealer and Associated Planners Investment Advisory, Inc., an investment advisor registered with the SEC pursuant to the Investment Advisers Act of 1940. WFG, an Illinois corporation, is an introducing broker-dealer registered with the SEC and the FINRA. The IASG entities engage primarily in introducing brokerage and advisory transactions for mutual funds, stocks, fixed income instruments, variable annuities, and other insurance products to third-party clearing broker-dealers on behalf of IFAs. The IASG entities have a consolidated sales force of approximately 2,100 registered IFAs.

IAG is an investment adviser registered with the SEC pursuant to the Investment Advisers Act of 1940, which offers an investment advisory platform for customers of financial advisors working for other financial institutions.

Innovex conducts real estate mortgage banking and brokerage activities. Innovex's primary business is originating residential mortgage loans for customers of IFAs who do business through its sister company, Linsco, throughout the United States. Innovex originates, underwrites, and funds a variety of mortgage and home equity loan products to suit the needs of borrowers. Innovex's revenues are derived from the referral of loans to lenders and the origination and sale of residential real estate loans for placement in the secondary market. Innovex is a Housing and Urban Development ("HUD") approved Title II nonsupervised mortgagee.

LPL Insurance Associates operates as a brokerage general agency for fixed insurance sales and services.

PTCH is a holding company for The Private Trust Company, N.A. ("PTC"). PTC has been chartered as a national bank with limited trust powers since August 1995, providing a wide range of trust, investment management, and custodial services for estates and families. PTC also provides Individual Retirement Account custodial services for its sister affiliate, Linsco.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Basis of Presentation*** These consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, which require the Company to make estimates and assumptions regarding the valuation of certain financial instruments, intangible assets, allowance for doubtful accounts, accruals for liabilities and income taxes, revenue and expense accruals, and other matters that affect the consolidated financial statements and related disclosures. Actual results could differ materially from those estimates.

***Reclassifications*** Certain reclassifications were made to prior period amounts to conform to the current period presentation. $1.44 million of fee revenues, which had been presented as Other revenue for the three and six months ended June 30, 2007, was reclassified as Transaction and other fees for the nine months ended September 30, 2007. These reclassifications had no effect on reported earnings, working capital, or stockholders' equity.

***Consolidation*** The Company consolidates all subsidiaries for which it has a controlling interest as defined by and in accordance with Accounting Research Bulletin No. 51, *Consolidated Financial Statements*.

All intercompany balances and transactions have been eliminated in consolidation. The Company accounts for the ownership of nonvoting common stock in PTCH as a minority interest. As of September 30, 2007, minority interest was $8,000 and is included in accounts payable and accrued liabilities in the accompanying consolidated statements of financial condition. The related minority interest expense is recorded in the accompanying consolidated statements of income.

***Comprehensive Income (Loss)*** The Company's comprehensive income (loss) is composed of net income and the effective portion of the unrealized gains (losses) on financial derivatives in cash flow hedge relationships, net of related tax effects.

***Cash and Cash Equivalents*** Cash and cash equivalents are composed of interest and noninterest-bearing deposits, money market funds, and U.S. government obligations that meet the definition of a cash equivalent. Cash equivalents are highly liquid investments, with original maturities of less than 90 days, that are not required to be segregated under federal or other regulations.

***Cash and Securities Segregated Under Federal and Other Regulations*** Certain of the Company's subsidiaries are subject to requirements related to maintaining cash or qualified securities in a segregated reserve account for the exclusive benefit of its customers in accordance with SEC Rule 15c3-3 and other regulations. At September 30, 2007 and December 31, 2006, the Company had $87.56 million and $52.18 million, respectively, in cash and securities segregated in special reserve bank accounts for the benefit of customers.

***Receivable From and Payable to Customers*** Receivable from and payable to customers includes amounts due on cash and margin transactions. The Company extends credit to its customers to finance their purchases of securities on margin. The Company receives income from interest charged on such extensions of credit. The Company pays interest on certain customer free credit balances held pending investment. Loans to customers are generally fully collateralized by customer securities, which are not included in the accompanying consolidated statements of financial condition.

To the extent that margin loans and other receivables from customers are not fully collateralized by customer securities, management establishes an allowance that it believes is sufficient to cover any probable losses. When establishing this allowance, management considers a number of factors, including its ability to collect from the customer and/or the customer's IFA and the Company's historical experience in collecting on such transactions. As of September 30, 2007 and December 31, 2006, the allowances were $502,000 and $202,000, respectively.

***Receivable From Product Sponsors, Broker-Dealers, and Clearing Organizations*** Receivable from product sponsors, broker-dealers, and clearing organizations primarily consists of commission and transaction-related receivables.

***Receivable From Others*** Receivable from others primarily consists of other accrued fees from product sponsors and financial advisors. The Company periodically extends credit to its IFAs in the form of recruiting loans, commission advances, and other loans. The decisions to extend credit to IFAs are generally based on either the IFAs credit history, his or her ability to generate future commissions, or both. Management maintains an allowance for uncollectible amounts using an aging analysis that takes into account the IFAs registration status and the specific type of receivable. The aging thresholds and specific percentages used represent management's best estimates of probable losses. Management monitors the adequacy of these estimates through periodic evaluations against actual trends experienced.

The following schedule shows the Company's activity in providing for an allowance for uncollectible amounts due from others (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Beginning balance January 1 | $ 2,590 | $ 2,529 |
| Provision | 398 | 533 |
| Charge-offs net of recoveries | (11) | (260) |
| Ending balance September 30 | $ 2,977 | $ 2,802 |

***Securities Owned and Sold But Not Yet Purchased*** Securities owned and securities sold but not yet purchased are reflected on a trade-date basis at market value with realized and unrealized gains and losses being recorded in other revenue in the consolidated statements of income. Customers' securities transactions are recorded on a settlement-date basis, with related commission income and expense reported on a trade-date basis.

U.S. government notes, held by PTCH, are classified as held-to-maturity, as PTCH has both the intent and ability to hold them to maturity. PTCH also invests in stock held in the Federal Reserve Bank, which is a nonmarketable security. U.S. government notes are carried at amortized cost, and stock held in the Federal Reserve Bank is carried at cost.

Interest income is accrued as earned and dividends are recorded on the ex-dividend date. Premiums and discounts are amortized, using a method that approximates the effective yield method, over the term of the security and recorded as an adjustment to the investment yield.

***Securities Borrowed and Loaned*** Securities borrowed and securities loaned are accounted for as collateralized financings and are recorded at the amount of the cash provided for securities borrowed transactions and cash received for securities loaned (generally in excess of market values). The adequacy of the collateral deposited for securities borrowed is continuously monitored and adjusted when considered necessary to minimize the risk associated with this activity. At September 30, 2007 and December 31, 2006, the Company had $7.34 million and $12.69 million, respectively, in securities borrowed. The collateral received for securities loaned is generally cash and is adjusted daily through the Depository Trust Company's ("DTC") net settlement process, and securities loaned is included in payable to broker-dealers and clearing organizations in the consolidated statements of financial condition. Securities loaned generally represent customer securities that can be pledged under standard margin loan agreements. At September 30, 2007 and December 31, 2006, the Company had $23.89 million and $14.88 million, respectively, of pledged securities loaned under the DTC Stock Borrow Program.

***Equity Investment*** The Company's equity investment is accounted for under the equity method when it exerts significant influence and ownership does not exceed 50% of the common stock. In accordance with Accounting Principles Board ("APB") Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* ("APB 18"), the Company records the investment at cost in the consolidated statements of financial condition and adjusts the carrying amount of the investment to recognize it's share of earnings or losses while recording such earnings or losses within the consolidated statements of income.

***Mortgage Loans Held for Sale*** The Company originates residential mortgage loans through a warehouse line of credit facility or as a broker for other banks. Mortgage loans held for sale are carried at the lower of aggregate cost or fair value and are sold on a nonrecourse basis with certain representations and warranties. Fair value is determined by outstanding commitments from investors. The Company evaluates the need for market valuation reserves on mortgage loans held for sale based on a number of quantitative and qualitative factors, primarily changes in interest rates and collateral values. The Company sells all mortgage loans that it originates. At September 30, 2007, the Company assessed the market value of such loans as being equal to or greater than cost. Accordingly, no reserve has been established.

The Company has an agreement with certain third-party financial institutions for them to purchase loans originated by the Company, as long as such loans meet certain criteria, generally within 30 days from funding. Loan origination and processing fees and certain direct origination costs are deferred until the related loan is sold.

***Fixed Assets*** Furniture, equipment, computers, purchased software, capitalized software, and leasehold improvements are recorded at historical cost, net of accumulated depreciation and amortization. Depreciation is recognized using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the lesser of their useful lives or the terms of the underlying leases, ranging up to 12 years. Equipment, furniture, fixtures, computers, and purchased software are depreciated over periods of three to seven years. Automobiles have depreciable lives of five years. Management reviews fixed assets for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable.

***Software Development Costs*** Software development costs are charged to operations as incurred. Software development costs include costs incurred in the development and enhancement of software used in connection with services provided by the Company that do not otherwise qualify for capitalization under the American Institute of Certified Public Accountants Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* ("SOP 98-1").

The costs of internally developed software that qualify for capitalization under SOP 98-1 are capitalized as fixed assets and subsequently amortized over the estimated useful life of the software, which is generally three years. The costs of internally developed software are included in fixed assets at the point at which the conceptual formulation, design, and testing of possible software project alternatives are complete and management authorizes and commits to funding the project. The

Company does not capitalize pilot projects and projects where it believes that the future economic benefits are less than probable. The value assigned to internally developed software in connection with certain acquisitions is amortized over an expected weighted-average economic useful life of approximately 4.3 years.

***Deferred Loan Issuance Costs*** Debt issuance costs incurred in connection with the issuance of the senior secured credit facilities and the senior unsecured subordinated notes have been capitalized and are being amortized as additional interest expense over the expected terms of the related debt agreements using the effective interest method.

***Goodwill*** Goodwill represents the cost of acquired companies in excess of the fair value of net tangible assets at acquisition date. Value was assigned to the Company's goodwill in conjunction with certain acquisitions (see Notes 1 and 3). In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"), goodwill is not amortized, but tested annually for impairment (in December), or more frequently if certain events having a material impact on the Company's value occur. No impairment occurred for the three and nine-month periods ended September 30, 2007 and 2006.

***Intangible Assets*** Intangible assets, which consist of relationships with IFAs, FAs, and product sponsors, are amortized on a straight-line basis over their estimated useful lives. The Company evaluates the remaining useful lives of intangible assets each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. Intangible assets are also tested for potential impairment whenever events or changes in circumstances suggest that an asset's or asset group's carrying value may not be fully recoverable in accordance with SFAS No. 144, *Accounting for the Impairment of Disposal of Long-Lived Assets* ("SFAS 144"). An impairment loss, calculated as the difference between the estimated fair value and the carrying value of an asset or asset group, is recognized if the estimated fair value is less than the corresponding carrying value. No impairment occurred for the three and nine-month periods ended September 30, 2007 and 2006.

***Trademarks and Trade Names*** The Company's business is highly dependent on its IFAs, and, as a result, expenditures are regularly made to market the Company's trademarks and trade names to them. The Company's primary trademarks and trade names were determined to have an indefinite life, and will be tested for potential impairment annually or whenever events or changes in circumstances suggest that the carrying value of such asset may not be fully recoverable in accordance with SFAS 142. An impairment loss, calculated as the difference between the estimated fair value and the carrying value of an asset or asset group, is recognized if the estimated fair value is less than the corresponding carrying value. Trademarks and trade names of certain acquired subsidiaries (representing $2.76 million) were determined to have finite lives and are being amortized over their expected useful lives of 18 months to five years. No impairment occurred for the three and nine-month periods ended September 30, 2007 and 2006.

***Classification and Valuation of Certain Investments*** The classification of an investment determines its accounting treatment. The Company generally classifies its investments in debt and equity instruments (including mutual funds, annuities, corporate bonds, government bonds, and municipal bonds) as trading securities, except for government bonds held by PTCH, which are classified as held-to-maturity based on management's intent. The Company has not classified any investments as available-for-sale. Investment classifications are subject to ongoing review and can change. Securities classified as trading are carried at fair value, while securities classified as held-to-maturity are carried at amortized cost. When possible, the fair value of securities is determined by obtaining quoted market prices. The Company also makes estimates about the fair value of investments and the timing for recognizing losses based on market conditions and other factors. If its estimates change, the Company may recognize additional losses. Both unrealized and realized gains and losses on trading securities are recognized in other revenue on a net basis in the consolidated statements of income.

***Derivative Instruments and Hedging Activities*** The Company periodically uses financial derivative instruments, such as interest rate swap agreements, to protect itself against changing market prices or interest rates and the related impact to the Company's assets, liabilities, or cash flows. The Company also evaluates its contracts and commitments for terms that qualify as embedded derivatives. All derivatives are reported at their corresponding fair value in the Company's consolidated statements of financial condition.

Financial derivative instruments expected to be highly effective hedges against changes in cash flows are designated as such upon entering into the agreement. At each reporting date, the Company reassesses the effectiveness of the hedge to determine whether or not it can continue to use hedge accounting. Under hedge accounting, the Company records the increase or decrease in fair value of the derivative, net of tax impact, as other comprehensive income or loss. If the hedge is not determined to be a perfect hedge, yet is still considered highly effective, the Company will calculate the ineffective portion and record the related change in its fair value as additional interest income or expense in the consolidated statements of income. Amounts accumulated in other comprehensive income (loss) are reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings.

***Drafts Payable*** Drafts payable represent customer checks drawn against the Company that have not yet cleared through the bank.

***Legal Reserves*** The Company records reserves for legal proceedings in accounts payable and accrued liabilities in the accompanying consolidated statements of financial condition. The determination of these reserve amounts requires significant judgment on the part of management. Management considers many factors, including, but not limited to, the amount of the claim, the amount of the loss in the customer's account, the basis and validity of the claim, the possibility of wrongdoing on the part of an IFA, likely insurance coverage, previous results in similar cases, and legal precedents and case law. Each legal proceeding is reviewed with counsel in each accounting period and the reserve is adjusted as deemed appropriate by management. Any change in the reserve amount is recorded as professional services in the accompanying consolidated statements of income.

***Estimates of Effective Income Tax Rates, Deferred Income Taxes, and Valuation Allowances*** In preparing the consolidated financial statements, the Company estimates the income tax expense based on the various jurisdictions where the Company conducts business. The Company must then assess the likelihood that the deferred tax assets will be realized. A valuation allowance is established to the extent that it is more likely than not that such deferred tax assets will not be realized. When the Company establishes a valuation allowance or modifies the existing allowance in a certain reporting period, the Company generally records a corresponding increase or decrease to tax expense in the consolidated statements of income. Management makes significant judgments in determining the provision for income taxes, the deferred tax assets and liabilities, and any valuation allowances recorded against the deferred tax asset. Changes in the estimate of these taxes occur periodically due to changes in the tax rates, changes in the business operations, implementation of tax planning strategies, resolution with taxing authorities of issues where the Company had previously taken certain tax positions, and newly enacted statutory, judicial, and regulatory guidance. These changes, when they occur, affect accrued taxes and can be material to the Company's operating results for any particular reporting period.

Additionally, the Company accounts for uncertain tax positions in accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 48, *Accounting for Uncertainty in Income Taxes  an interpretation of FASB Statement No. 109* ("FIN 48"). The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. The Company is required to make many subjective assumptions and judgments regarding our income tax exposures. Interpretations of and guidance surrounding income tax laws and regulations change over time. As such, changes in the Company's subjective assumptions and judgments can materially affect amounts recognized in the consolidated statements of financial condition and statements of income. See Note 11 for additional detail regarding the Company's uncertain tax positions.

***Revenue Recognition Policies:***

***Commissions***  The Company records commissions received from mutual funds, annuity, insurance, equity, fixed income, direct investment, option, and commodity transactions on a trade-date basis. Commissions also include mutual fund and variable annuity trails, which are recognized as earned as a percentage of assets under management over the period for which services are performed. Due to the significant volume of mutual fund and variable annuity purchases and sales transacted by IFAs directly with product manufacturers, management must estimate a portion of its upfront commission and trail revenues for each accounting period for which the proceeds have not yet been received. These estimates are based on a number of factors, but primarily on the volume of similar transactions for the same period for which cash has been received. Because the Company records commissions payable based upon standard payout ratios for each product as it accrues for commission revenue, any adjustment between actual and estimated commission revenue will be offset in part by the corresponding adjustment to commissions payable.

***Advisory and Asset-Based Fees***  The Company charges investment advisory fees based on a customer's portfolio value, generally at the beginning of each quarter. Advisory fees collected in advance are recorded as unearned revenue and are recognized ratably over the period in which such fees are earned. Advisory fees collected in arrears are recorded as earned. Asset-based fees are primarily derived from the Company's marketing, sub-transfer agency agreements, and customer cash sweep products and are recorded and recognized ratably over the period in which services are provided.

***Transaction and Other Fees***  The Company charges transaction fees for executing noncommissionable transactions on customer accounts. Transaction-related charges are recognized on a trade-date basis. Other fees relate to services provided and other account charges generally outlined in the Company's agreements with its IFAs and customers. Such fees are recognized as services are performed or as earned, as applicable. In addition, the Company offers various software-related products which it charges on a subscription basis. Fees are recognized over the subscription period.

***Interest Income***  The Company earns interest income from its cash equivalents, customer margin balances, and on mortgage loans held for sale.

***Gain on Sale of Mortgage Loans Held for Sale***  The Company recognizes gains on the sale of mortgage loans held for sale on the date of settlement. A gain is recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold, including deferred loan origination fees and certain direct origination costs. All loans are sold on a servicing-released basis, the Company does not service the loans after they are sold, and it generally sells all loans before first payment is made. Loans are accounted for as sold when control of the mortgage loans is surrendered. Control over mortgage loans is deemed to be surrendered when (i) the mortgage loans have been isolated from the Company, (ii) the buyer has the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the loans, and (iii) the Company does not maintain effective control of the mortgage loans through either (a) an agreement that entitles and obligates the Company to repurchase or redeem the mortgage loans before maturity or (b) the ability to unilaterally cause the buyer to return specific mortgage loans.

***Compensation and Benefits*** The Company records compensation and benefits for all cash and deferred compensation, benefits, and related taxes as earned by its employees. Compensation and benefits expense also includes fees earned by temporary employees and contractors who perform similar services to those performed by the Company's employees, primarily software development and project management activities. Temporary employee and contractor services of $7.15 million and $14.79 million were incurred during the three and nine months ended September 30, 2007, respectively, and $3.53 million and $10.30 million were incurred during the three and nine months ended September 30, 2006, respectively.

***Share-Based Compensation*** On January 1, 2006, the Company adopted SFAS No. 123R (Revised), *Share-Based Payment*, ("SFAS 123R"). SFAS 123R requires the recognition of the fair value of share-based compensation in net income. The Company recognizes share-based compensation expense over the requisite service period of the individual grants, which generally equals the vesting period. Prior to January 1, 2006, the Company accounted for employee equity awards using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, ("APB 25") and related interpretations in accounting for share-based compensation.

The Company has adopted the provisions of SFAS 123R using the prospective transition method, whereby it will continue to account for nonvested equity awards to employees outstanding prior to January 1, 2006, using APB 25, and apply SFAS 123R to all awards granted or modified after that date. In accordance with the transition rules of SFAS 123R, the Company no longer provides pro forma disclosures illustrating what net income would have been had the Company valued share-based awards under a fair value method rather than under the intrinsic value method of APB 25.

The Company recognized $349,000 and $1.05 million of share based compensation for the three and nine months ended September 30, 2007, respectively, and $680,000 and $2.14 million of share based compensation for the three and nine months ended September 30, 2006, respectively, under APB 25 related to the vesting of stock options awarded to employees prior to January 1, 2006. As of September 30, 2007, approximately $349,000 remains in unrecognized compensation for those awards, which is expected to be recognized ratably through December 31, 2007, its final vesting period.

The Company also recognized $249,000 and $453,000 of share-based compensation under SFAS 123R related to stock options awarded to employees for the three and nine months ended September 30, 2007, respectively. As of September 30, 2007, total unrecognized compensation cost related to nonvested share-based compensation arrangements granted was $5.13 million, which is expected to be recognized over a weighted-average period of 5.87 years. Under SFAS 123R, the Company calculates the compensation cost for stock options based on its estimated fair value. As there are no observable market prices for identical or similar instruments, the Company estimates fair value using a Black-Scholes valuation model. The following table presents the weighted-average assumptions used by the Company in calculating the fair value of stock options with the Black-Scholes valuation model with the following assumptions for the three and nine months ended September 30, 2007:

| | Nine months ended September 30, | |
|---|---|---|
| | **2007** | **2006** |
| Expected life (in years) | 6.49 | 6.27 |
| Expected stock price volatility | 31.45% | 34.89% |
| Expected dividend yield | | |
| Annualized forfeiture rate | 0.27% | 0.27% |
| Fair value of options | $ 93.16 | $ 46.01 |
| Risk-free interest rate | 5.19% | 5.16% |

The risk-free interest rates are based on the implied yield available on U.S. Treasury constant maturities in effect at the time of the grant with remaining terms equivalent to the respective expected terms of the options. The Company has elected to use the shortcut approach in accordance with SEC Staff Accounting Bulletin No. 107, *Share-Based Payment*, to develop the estimate of the expected term. Expected volatility is calculated based on companies of similar growth and maturity and the Company's peer group in the industry in which the Company does business because the Company does not have sufficient historical volatility data. The Company will continue to use peer group volatility information until historical volatility of the Company is relevant to measure expected volatility for future option grants. The dividend yield of zero is based on the fact that the Company has no present intention to pay cash dividends. In the future, as the Company gains historical data for volatility in its own stock and the actual term over which employees hold its options, expected volatility, and the expected term may change, which could substantially change the grant-date fair value of future awards of stock options and, ultimately, compensation recorded on future grants.

The Company has assumed an annualized forfeiture rate of 0.27% for its options based on a combined review of industry and employee turnover data, as well as an analytical review performed of historical prevesting forfeitures occurring over the previous year. Under the true-up provisions of SFAS 123R, the Company will record additional expense if the actual forfeiture rate is lower than estimated and will record a recovery of prior expense if the actual forfeiture is higher than estimated.

***Fair Value of Financial Instruments*** The Company's financial assets and liabilities are carried at fair value or at amounts that, because of their short-term nature, approximate current fair value.

Customer receivables, primarily consisting of floating rate margin loans collateralized by customer securities, are charged interest at rates similar to such other loans made within the industry.

***Commitments and Contingencies*** The Company recognizes liabilities for contingencies when analysis indicates it is both probable that a liability has been incurred and the amount of loss can be reasonably estimated. When a range of probable loss can be estimated, the Company accrues the most likely amount.

Management evaluates all available evidence about asserted and unsettled income tax contingencies and unasserted income tax contingencies caused by uncertain income tax positions taken in the Company's income tax returns filed with the Internal Revenue Service and state and local tax authorities. Contingencies that management believes are estimable and probable of payment, if successfully challenged by such tax authorities, are accrued for under the provisions of FIN 48.

***Recently Issued Accounting Pronouncements*** In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option of Financial Assets and Financial Liabilities* ("SFAS 159"). This standard permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact that the adoption of SFAS 159 will have on its consolidated statements of financial condition, statements of income, or cash flows.

On January 1, 2007, the Company adopted the provisions FIN 48, which clarifies the accounting uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, *Accounting for Income Taxes*. FIN 48 requires the Company to recognize in the consolidated financial statements the tax benefits of a position only if it is "more likely than-not" to be sustained based solely on its technical merits, otherwise no benefits of the position are to be recognized. Moreover, the more-likely-than-not threshold must continue to be met in each reporting period to support continued recognition of a benefit. The impact of the Company's reassessment of its tax positions in accordance with FIN 48 resulted in a reduction to stockholder's equity of $4.45 million, which has been recorded as a cumulative change in accounting principle (see Note 11).

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"). This standard provides guidance for using fair value to measure assets and liabilities. Under SFAS 157, 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. In this standard, the FASB 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, SFAS 157 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; for example, the reporting entity's own data. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The provisions of SFAS 157 are not expected to have a material impact on the Company's consolidated financial statements.

**3. ACQUISITIONS**

The Company has completed three acquisitions during the period January 1, 2007 through September 30, 2007.

*IASG*

On June 20, 2007, the Company acquired IASG, strengthening the Company's position as a leading independent broker-dealer in the United States. In accordance with SFAS 141, the acquisition has been accounted for under the purchase method of accounting, which required the purchase price, estimated to be approximately $120.48 million ($63.34 million in cash and the issuance of 264,550 shares of common stock with an estimated fair value of $216.00 per share) to be allocated to the specific tangible and intangible assets acquired and liabilities assumed based on their fair market values at the date of acquisition. The preliminary purchase price allocations are subject to adjustment as additional information is obtained.

The purchase price was allocated as follows (in thousands):

| | | |
|---|---|---|
| Assets purchased and liabilities assumed: | | |
| Cash | $ | 38,091 |
| Receivables | | 10,888 |
| Investments | | 1,681 |
| Fixed assets | | 1,960 |
| Goodwill | | 11,752 |
| Intangibles | | 67,100 |
| Trademarks and trade names | | 2,300 |
| Prepaids | | 1,204 |
| Other assets | | 19,813 |
| Accounts payable and accrued liabilities | | (34,310) |
| Total purchase price | $ | 120,479 |

As part of the purchase price allocation, the Company estimated the value of intangible assets for relationships with financial advisors and product sponsors. The value assigned to these relationships was $67.10 million, which will be amortized on a straight-line basis over their expected useful lives ranging from 10 to 20 years. Additionally, the Company estimated the value of trademarks and trade names in the amount of $2.30 million. The trademarks and trade names were determined to have an expected useful life of three to five years and therefore amortized over the same period, in accordance with SFAS 142.

The excess of the aggregate purchase price over the value of assets and liabilities assumed resulted in goodwill of $11.75 million. In accordance with SFAS 142, goodwill will not be amortized, but reviewed at least annually for impairment.

The acquisition was treated as a purchase of assets and liabilities for federal tax purposes. Accordingly, the amounts allocated to goodwill of $11.75 million, intangible assets of $67.10 million, and trademarks and trade names of $2.30 million are deductible for federal tax purposes over a 15-year period.

*UVEST*

On January 2, 2007, the Company completed its acquisition of UVEST, augmenting the Company's position in providing services to banks, credit unions, and other financial institutions. In accordance with SFAS 141, the acquisition has been accounted for under the purchase method of accounting, which required the purchase price of approximately $88.80 million ($77.36 million in cash and the issuance of 60,366 shares of common stock at an estimated fair value of $189.00 per share) to be allocated to the specific tangible and intangible assets acquired and liabilities assumed based on their fair market values at the date of acquisition. The preliminary purchase price allocations are subject to adjustment as additional information is obtained.

The purchase price was allocated as follows (in thousands):

| | | |
|---|---|---|
| Assets purchased and liabilities assumed: | | |
| Cash | $ | 14,124 |
| Accounts receivable | | 7,241 |
| Fixed assets | | 5,093 |
| Goodwill | | 28,397 |
| Intangibles | | 54,312 |
| Trademark and trade name | | 457 |
| Prepaids | | 335 |
| Other assets | | 492 |
| Accounts payable and accruals | | (21,648) |
| Total purchase price | $ | 88,803 |

As part of the purchase price allocation, the Company recorded intangible assets for relationships with financial advisors and product sponsors. The value assigned to these relationships was $54.31 million, which will be amortized on a straight-line basis over the expected useful life of 20 years. Additionally, the Company assigned value to UVEST's trademark and trade name in the amount of $457,000. The trademark and trade name was determined to have an expected useful life of 18 months and therefore amortized over the same period, in accordance with SFAS 142.

As a result of the acquisition, goodwill in the amount of $28.40 million was created for the excess purchase price over the value of assets and liabilities assumed. In accordance with SFAS 142, goodwill will not be amortized, but reviewed at least annually for impairment.

The acquisition was treated as a purchase of assets and liabilities for federal tax purposes. Accordingly, the amounts allocated to goodwill of $28.40 million, intangible assets of $54.31 million, and trademark and trade name of $457,000 are deductible for federal tax purposes over a 15-year period.

Immediately following the acquisition, the Company satisfied certain obligations under a phantom stock plan for UVEST employees by issuing 6,582 shares of common stock at an estimated fair value of $189.00 per share.

The following unaudited pro forma table shows the results of the Company's operations for the specified reporting periods as though the aforementioned acquisitions had occurred as of the beginning of those periods (in thousands):

| | Three months Ended September 30, | | Nine months Ended September 30, | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Revenue | $ 725,017 | $ 539,538 | $ 2,123,934 | $ 1,625,899 |
| Net Income | $ 11,567 | $ 3,788 | $ 53,997 | $ 16,077 |

The pro forma results have been prepared for comparative purposes only and are not necessarily indicative of the actual results of operations had the acquisition taken place as of the beginning of the periods presented, or the results that may occur in the future.

*Asset Acquisitions*

On May 9, 2007, and August 9, 2007, LPLH and its parent, LPLIH, entered into Institutional Transfer Agreements with multiple institutions, resulting in the transfer of institutional relationships to its broker-dealer subsidiaries. As consideration for these relationships, the Company paid $2.97 million in cash and issued 4,386 shares of common stock valued at $255.00 per share. The Company has recorded intangible assets for the value of these relationships and is currently evaluating the estimated useful lives, the period over which it will amortize such amounts.

## 4. EQUITY INVESTMENT

On May 11, 2007, the Company acquired for $5.00 million, an approximate 22.6% ownership interest in a privately held technology company that, provides middleware solutions and straight-through processing for the life insurance and annuities industry. This investment provides the Company with a strategic ownership interest in one of its vendors that provides technology for variable annuity order entry and monitoring. This investment is classified as other assets in the consolidated statements of financial condition and the Company's share of gains and losses are recognized in the consolidated statements of income in accordance with APB 18.

**5. RECEIVABLE FROM PRODUCT SPONSORS, BROKER-DEALERS, AND CLEARING ORGANIZATIONS AND PAYABLE TO BROKER-DEALERS AND CLEARING ORGANIZATIONS**

Receivable from product sponsors, broker-dealers, and clearing organizations and payable to broker-dealers and clearing organizations were as follows (in thousands):

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Receivables: | | |
| Securities failed-to-deliver | $ 3,999 | $ 3,407 |
| Receivable from broker-dealers | 21,934 | 12,413 |
| Receivable from clearing organizations | 5,048 | 7,853 |
| Commissions receivable from product sponsors and others | 98,600 | 66,033 |
| Total receivables | $ 129,581 | $ 89,706 |
| Payables: | | |
| Securities failed-to-receive | $ 15,637 | $ 6,628 |
| Payable to broker-dealers | 7,661 | 296 |
| Payable to clearing organizations | 9,192 | 8,547 |
| Securities loaned | 26,385 | 14,883 |
| Total payables | $ 58,875 | $ 30,354 |

Securities loaned represent amounts due to DTC for collateral received in participation with its stock borrow program.

Linsco clears commodities transactions for its customers through another broker-dealer on a fully disclosed basis. The amount payable to broker-dealers relates to the aforementioned transactions and is collateralized by securities owned by Linsco.

**6. SECURITIES OWNED AND SECURITIES SOLD BUT NOT YET PURCHASED**

The components of securities owned and securities sold but not yet purchased were as follows (in thousands):

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Securities owned market value: | | |
| Mutual funds | $ 10,688 | $ 6,149 |
| U.S. government obligations (pledged to clearing organizations) | 2,684 | 2,643 |
| Nonconvertible bonds | 1,732 | |
| Stocks and warrants | 490 | 444 |
| Variable annuities | 239 | 227 |
| Money market funds | 160 | 61 |
| Unit investment trust | 10 | |
| Total securities owned market value | $ 16,003 | $ 9,524 |
| Other securities: | | |
| U.S. government notes at amortized cost | $ 8,530 | $ 10,242 |
| Federal Reserve stock at cost | 389 | 393 |
| Total other securities | $ 8,919 | $ 10,635 |
| Securities sold but not yet purchased market value: | | |
| Mutual funds | $ 4,873 | $ 10,578 |
| Stocks and warrants | 27 | 218 |
| Non-convertible bonds | 13 | 10 |
| U.S. government obligations | 11 | |
| Total securities sold but not yet purchased market value | $ 4,924 | $ 10,806 |

The carrying values of the U.S. government notes classified as held-to-maturity approximates their market values. As of September 30, 2007, the components of U.S. government notes classified as held-to-maturity were as follows (in thousands):

| | Carrying Values | Interest Rate | Year of Maturity |
|---|---|---|---|
| U.S. Treasury notes | $ 1,599 | 3.00% 4.25% | 2007 |
| U.S. Treasury notes | 6,443 | 3.25 4.875 | 2008 |
| U.S. Treasury notes | 488 | 3.00 | 2009 |
| Total U.S. Treasury Notes | $ 8,530 | | |

**7. MORTGAGE LOANS HELD FOR SALE**

At September 30, 2007, mortgage loans held for sale consist of first deed mortgages on residential properties located in California and other states throughout the United States. Innovex had no second deeds of trust held for sale. The loans held for sale are pledged as collateral for the warehouse lines of credit described in Note 14. The following schedule summarizes the components of mortgage loans held for sale (in thousands):

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Mortgage loans held for sale | $ 3,732 | $ 4,395 |
| Net deferred loan origination fees | (19) | (18) |
| Basis adjustment from interest rate lock loan commitment | 6 | (15) |
| Mortgage loans held for sale net | $ 3,719 | $ 4,362 |

**8. FIXED ASSETS**

The components of fixed assets are as follows (in thousands):

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Computers and software | $ 64,592 | $ 44,995 |
| Furniture and equipment | 20,541 | 13,885 |
| Property | 6,572 | 6,572 |
| Leasehold improvements | 20,817 | 18,175 |
| Internally developed software | 152,961 | 128,698 |
| Total fixed assets | 265,483 | 212,325 |
| Accumulated depreciation and amortization | (123,804) | (90,731) |
| Fixed assets net | $ 141,679 | $ 121,594 |

Depreciation and amortization expense for fixed assets was $11.07 million and $31.40 million for the three and nine months ended September 30, 2007, respectively, and $9.08 million and $26.84 million for the three and nine months ended September 30, 2006, respectively.

**9. INTANGIBLE ASSETS**

In conjunction with various business combinations, the Company has recorded intangible assets representing lists and relationships with IFAs, product sponsors, and trust clients. Identifiable intangible assets are tested for potential impairment whenever events or changes in circumstances suggest that the carrying value of an asset or asset group may not be fully recoverable in accordance with SFAS 144. These intangible assets are amortized on a straight-line basis over their estimated economic useful lives ranging from five to 20 years. Total amortization expense of intangible assets was $8.89 million and $25.03 million for the three and nine months ended September 30, 2007, respectively, and $8.89 million and $25.03 million for the three and nine months ended September 30, 2006, respectively.

Amortization expense for each of the fiscal years ended December 2007 through 2011 and thereafter is estimated as follows (in thousands):

| | |
|---|---|
| 2007 remainder | $ 9,182 |
| 2008 | 36,465 |
| 2009 | 35,998 |
| 2010 | 35,180 |
| 2011 | 35,180 |
| Thereafter | 483,784 |
| Total | $ 635,789 |

**10. TRADEMARKS AND TRADE NAMES**

The Company is highly dependent on the revenues generated from its good standing relationships with its IFAs, FAs, and product sponsors. In connection with its various business combinations, the Company has assigned value to the trademarks and trade names acquired. The Company's primary trademarks and trade names were determined to have an indefinite life, and will be tested for potential impairment annually or whenever events or changes in circumstances suggest that the carrying value of such asset may not be fully recoverable in accordance with SFAS 142. Trademarks and trade names of acquired subsidiaries (representing $2.76 million) were determined to have finite lives. These trademarks and trade names are amortized on a straight-line basis over their estimated economic useful lives of 18 months to five years. Total amortization expense of trademarks and trade names was $55,000 and $379,000 for the three and nine months ended September 30, 2007, respectively.

Amortization expense for each of the fiscal years ended December 2007 through 2011 and thereafter is estimated as follows (in thousands):

| | |
|---|---|
| 2007 remainder | $ 212 |
| 2008 | 692 |
| 2009 | 540 |
| 2010 | 434 |
| 2011 | 340 |
| Thereafter | 160 |
| Total | $ 2,378 |

**11. INCOME TAXES**

The Company's provision (benefit) for income taxes is as follows (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Current provision: | | | | |
| Federal | $ 8,365 | $ 9,986 | $ 45,477 | $ 24,497 |
| State | 1,403 | (1,808) | 8,501 | 928 |
| Total current provision | 9,768 | 8,178 | 53,978 | 25,425 |
| Deferred benefit: | | | | |
| Federal | (2,811) | (7,084) | (12,820) | (14,344) |
| State | (312) | 2,378 | (2,085) | 1,067 |
| Total deferred benefit | (3,123) | (4,706) | (14,905) | (13,277) |
| Provision for income taxes | $ 6,645 | $ 3,472 | $ 39,073 | $ 12,148 |

The Company's effective income tax rate differs from the federal corporate tax rate of 35%, primarily as a result of state taxes, settlement contingencies, and nondeductible expenses for tax purposes. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

The components of the net deferred tax liabilities included in the consolidated statements of financial condition were as follows (in thousands):

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Deferred tax assets: | | |
| State taxes | $ 19,558 | $ 15,627 |
| Share-based compensation | 4,052 | 3,665 |
| Reserves for litigation, vacation, and bonuses | 4,790 | 2,590 |
| Deferred rent | 3,548 | 2,591 |
| Provision for bad debts | 1,437 | 1,159 |
| Unrealized loss on interest rate swaps | 811 | |
| Net operating losses of acquired subsidiaries | 445 | 589 |
| Other | 5 | 431 |
| Total deferred tax assets | 34,646 | 26,652 |
| Deferred tax liabilities: | | |
| Amortization of intangible assets and trademarks and trade names | (248,206) | (262,750) |
| Depreciation of fixed assets | (12,960) | (8,549) |
| Unrealized gain on interest rate swaps | | (1,250) |
| Other | (310) | |
| Total deferred tax liabilities | (261,476) | (272,549) |
| Deferred income taxes net | $ (226,830) | $ (245,897) |

As of September 30, 2007, the Company had federal net operating loss carryforwards from acquired subsidiaries of approximately $1.27 million. The federal net operating losses are subject to an annual limitation on their utilization of approximately $412,000. If not utilized, the federal net operating losses will expire between 2011 and 2022. The Company has not recorded a valuation allowance against its deferred tax assets, as it is more likely than not all benefits will be utilized in future periods.

The Company adopted FIN 48 at the beginning of fiscal year 2007. FIN 48 requires a company to evaluate whether the tax position taken by a company will more likely than not be sustained upon examination by the appropriate taxing authority. It also provides guidance on how a company should measure the amount of benefit that the company is to recognize in its financial statements. As a result of the implementation of FIN 48, the Company recorded an additional reserve for uncertain tax positions in the amount of $4.45 million. This charge was accounted for as a cumulative effect of change in accounting principle, recorded directly to the Company's retained earnings. At the beginning of 2007, the Company had approximately $8.53 million of total gross unrecognized tax benefits. Of this total, $6.43 million (net of the federal benefit on state issues) represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in any future periods.

The Company and its subsidiaries file income tax returns in the federal jurisdiction, as well as most state jurisdictions, and are subject to routine examinations by the respective taxing authorities. The Company has concluded all federal and state income tax matters for years through 2003, with the exception of California, which has concluded income tax matters for years through 2002.

The Company's continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company had accrued approximately $567,000 for interest and $472,000 for penalties at the beginning of fiscal year 2007 (date of adoption), which has been recorded in the accompanying statements of financial condition.

We anticipate the unrecognized tax benefit may increase during the year for items that arise in the ordinary course of business. Such amounts will be reflected as an increase in the amount of unrecognized tax benefits and an increase to the current period tax expense. These increases will be considered in the determination of the Company's annual effective tax rate.

For the nine months ended September 30, 2007, we have accrued approximately $240,000 of interest and $1.00 million of penalties related to uncertain tax positions, which has been recorded in the Company's accompanying consolidated statements of income as income tax expense. The tax years 2004-2006 remain open to examination by the major taxing jurisdictions to which we are subject, with the exception of California discussed above.

## 12. INDEBTEDNESS

In connection with the Acquisition on December 28, 2005, the Company incurred indebtedness, including $795.00 million of borrowing under the senior secured credit facilities and $550.00 million of senior unsecured subordinated notes.

***Senior Secured Credit Facilities*** During 2007 and 2006, the Company's senior secured credit facilities consisted of the following:

- Tranche A Notes in the amount of $45.00 million that were issued to finance a portion of the cash consideration for the Acquisition. The notes were repaid in full in 2006.

Tranche B Notes in the amount of $750.00 million that were used to finance a portion of the cash contribution for the Acquisition. The notes were replaced with Tranche C as discussed below.

On December 29, 2006, the Company amended and replaced its Tranche B Notes with Tranche C Notes. The Tranche C Notes (in the amount of $794.38 million) provided the Company with an additional $50.00 million for the acquisition of UVEST (see Note 3), as well as certain enhancements to the terms of the original credit agreement, including a reduction to the applicable interest rate margin of 0.25%. The Tranche C Notes are due to mature on June 28, 2013. The Company will provide for quarterly amortization payments of 0.25% in an aggregate amount annually.

On June 18, 2007, the Company amended and replaced its Tranche C Notes with Tranche D Notes. The Tranche D Notes (in the amount of $842.39 million) provided the Company with an additional $50.00 million for the acquisition of IASG (see Note 3). Through this transaction the Company also reduced its applicable interest rate margin from 250 basis points to 200 basis points. The Tranche D Notes are due to mature on June 28, 2013. The Company will provide for quarterly amortization payments of 0.25% in an aggregate amount annually. Additional principal payments will be required if the Company achieves certain levels of annual cash earnings adjusted for changes in net working capital.

A $100.00 million revolving credit facility for future working capital and investment needs. This facility expires on December 28, 2011. Of the $100.00 million, $10.00 million has been utilized in the form of an irrevocable letter of credit for PTCH, which expires on December 28, 2007. The Company will pay 2.00% annually on the balance of the irrevocable letter of credit as well as a 0.23% fronting fee. The Company also pays a fee of 0.375% on the unused balance of the revolving credit facility. At September 30, 2007, there were no outstanding borrowings against the letter of credit.

The senior secured credit facilities are secured primarily through pledges of capital stock in the Company's subsidiaries. Borrowings under the senior secured credit facilities bear interest at a base rate plus an applicable interest rate margin, depending on the Company's consolidated leverage ratio, its corporate family rating by Moody's, and the source for the base rate. The Company elects the base rate and can choose between the lower of prime or the Interbank lending rate and the London Interbank Offering Rate ("LIBOR") with up to a twelve-month period. The applicable interest rate margin ranges between 1.00% and 2.00% (maximum was 2.25% prior to achieving a step-down resulting from a Moody's upgrade in the Company's corporate family rating from 'B2' to 'B1' with a positive outlook). The senior secured credit facilities are subject to certain financial and nonfinancial covenants. As of September 30, 2007, the Company was in compliance with all such covenants.

***Senior Unsecured Subordinated Notes*** The Company also has $550.00 million of senior unsecured subordinated notes due December 15, 2015. The notes bear interest at 10.75% per annum and interest payments are payable semiannually in arrears. The Company is not required to make mandatory redemption or sinking-fund payments with respect to the notes. Indentures underlying the senior subordinated notes contain various restrictions with respect to the issuer, including one or more restrictions relating to limitations on liens, sale and leaseback arrangements, and funded debt of subsidiaries. Additionally, the senior subordinated notes are subject to certain financial and nonfinancial covenants. As of September 30, 2007, the Company was in compliance with all such covenants.

***Bank Loans Payable*** The Company maintained uncommitted lines of credit, which have an unspecified limit, primarily dependent on the Company's ability to provide sufficient collateral. At September 30, 2007, the Company had a balance outstanding of $16.00 million. The lines were subsequently paid down in full on October 1, 2007.

The Company's outstanding borrowings were as follows (dollars in thousands):

| | | September 30, 2007 | | December 31, 2006 | |
|---|---|---|---|---|---|
| | **Maturity** | **Balance** | **Interest Rate** | **Balance** | **Interest Rate** |
| Senior secured notes (Tranche D): | | | | | |
| Unhedged | 6/28/2013 | $ 343,177 | 7.20%(2) | $ 299,375 | 8.11%(1) |
| Hedged with interest rate swaps | 6/28/2013 | 495,000 | 7.20(2) | 495,000 | 8.11(1) |
| Revolving credit | 12/28/2011 | | | | |
| Senior unsecured subordinated notes | 12/15/2015 | 550,000 | 10.75 | 550,000 | 10.75 |
| Letter of credit | 12/28/2007 | | | | |
| Bank loans payable | (4) | 16,000 | 5.75(3) | | |
| Total borrowings | | 1,404,177 | | 1,344,375 | |
| Less current borrowings (maturities within 12 months) | | 24,424 | | 7,944 | |
| Long-term borrowings net of current portion | | $ 1,395,753 | | $ 1,336,431 | |

(1) As of December 31, 2006, the variable interest rate for the Senior Secured Notes (Tranche C) is based on the three-month LIBOR of 5.36% plus the applicable interest rate margin of 2.75%.

(2) As of September 30, 2007, the variable interest rate for the Senior Secured Notes (Tranche D) is based on the three-month LIBOR of 5.20% plus the applicable interest rate margin of 2.00%.

(3) As of September 30, 2007, the variable interest rate for the bank loans payable is based on the Federal Funds Rate of 5.25% plus the applicable interest rate margin of 0.50%.

(4) The bank loans payable have no maturity date, as it is primarily dependent on the Company's ability to provide sufficient collateral.

The following summarizes borrowing activity in the revolving and margin credit facilities (dollars in thousands):

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Average balance outstanding | $ 1,827 | $ | $ 1,342 | $ 9,911 |
| Weighted-average interest rate | 5.78% | % | 6.24% | 6.71% |

The minimum calendar year principal payments and maturities of borrowings as of September 30, 2007, are as follows (in thousands):

| | Senior Secured | Line of Credit | Letter of Credit | Senior Unsecured | Total Amount |
|---|---|---|---|---|---|
| 2007 remainder | $ 2,106 | $ 16,000 | $ | $ | $ 18,106 |
| 2008 | 8,424 | | | | 8,424 |
| 2009 | 8,424 | | | | 8,424 |
| 2010 | 8,424 | | | | 8,424 |
| 2011 | 8,424 | | | | 8,424 |
| Thereafter | 802,375 | | | 550,000 | 1,352,375 |
| Total | $ 838,177 | $ 16,000 | $ | $ 550,000 | $ 1,404,177 |

**13. INTEREST RATE SWAPS**

On January 30, 2006, the Company entered into five interest rate swap agreements (the "Swaps"). An interest rate swap is a financial derivative instrument whereby two parties enter into a contractual agreement to exchange payments based on underlying interest rates. The Company uses the Swaps to hedge the variability on its floating rate senior secured notes. The Company is required to pay the counterparty to the agreement fixed interest payments on a notional balance, and in turn, receives variable interest payments on that notional balance. Payments are settled quarterly on a net basis.

The following table summarizes information related to the Company's Swaps as of September 30, 2007 (dollars in thousands):

| | Notional Balance | Fixed Pay Rate | Variable Receive Rate(1) | Fair Value | Maturity Date |
|---|---|---|---|---|---|
| Swap 1 | $ 70,000 | 4.76% | 5.20% | $ 38 | June 30, 2008 |
| Swap 2 | 95,000 | 4.77 | 5.20 | (339) | June 30, 2009 |
| Swap 3 | 120,000 | 4.79 | 5.20 | (659) | June 30, 2010 |
| Swap 4 | 145,000 | 4.83 | 5.20 | (808) | June 30, 2011 |
| Swap 5 | 65,000 | 4.85 | 5.20 | (300) | June 30, 2012 |
| | $ 495,000 | | | $ (2,068) | |

(1) The variable receive rate reset on the last day of the year is based on the applicable three-month LIBOR. The effective rate from June 29, 2007 through September 28, 2007, was 5.36%.

Each of the Swaps listed above have been designated as cash flow hedges against specific payments due on the Company's senior secured notes. As of September 30, 2007, the Company assessed the Swaps as being highly effective and expects them to continue to be highly effective. Accordingly, the changes in fair value of the Swaps have been recorded as other comprehensive loss, with the fair value of the Swaps included as a liability on the Company's consolidated statements of financial condition. Based on current interest rate assumptions and assuming no additional Swaps are entered into, the Company expects to reclassify approximately $1.97 million, or $1.14 million after tax, from other comprehensive loss as additional interest expense over the next 12 months.

## 14. WAREHOUSE LINES OF CREDIT

Innovex uses a warehouse line of credit for originating customer residential mortgage loans. This line of credit is collateralized by mortgage loans held for sale and also by a guarantee from the Company and provides for aggregate borrowings up to $15.00 million. The interest rate is based on 30 day's daily average lenders' reference rate, plus a minimum base margin rate of 2.25%. As of September 30, 2007, Innovex had total borrowings outstanding of $1.77 million bearing interest at 7.87%. The agreement requires the Company and Innovex to comply with certain financial and nonfinancial covenants. As of September 30, 2007, the Company and Innovex were in compliance with such covenants.

In 2006 the Company borrowed from two different lines of credit. The first provided for aggregate borrowings up to $9.00 million and bore interest based on the lenders' reference rate (LIBOR) plus a rate ranging between 2.50% and 4.75%, depending on the duration of the outstanding borrowings. The second line of credit bore interest based on the lender's reference rate (Prime) plus an additional rate ranging between 0% and 7%, depending on the duration of the outstanding borrowings with an overall floor of 5.25%. The $4.25 million of credit was due on demand and the line had no specified expiration date. Both lines of credit were terminated by the Company during 2006.

The following summarizes Innovex's borrowings on its warehouse facilities (dollars in thousands):

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Average balance outstanding | $ 2,403 | $ 3,117 | $ 3,813 | $ 1,961 |
| Maximum amount outstanding in any month-end during the period | $ 2,443 | $ 4,189 | $ 8,436 | $ 4,189 |
| Weighted-average interest rate during the period | 8.21% | 7.61% | 8.34% | 8.67% |

## 15. COMMITMENTS AND CONTINGENCIES

***Leases*** The Company leases certain office space and equipment at its headquarters locations under various operating leases. These leases are generally subject to scheduled base rent and maintenance cost increases, which are recognized on a straight-line basis over the period of the leases.

Future minimum calendar-year payments for operating lease commitments with remaining terms greater than one year as of September 30, 2007, are approximately as follows (in thousands):

| | |
|---|---|
| 2007 remainder | $ 4,398 |
| 2008 | 17,189 |
| 2009 | 17,628 |
| 2010 | 16,000 |
| 2011 | 13,444 |
| Thereafter | 32,761 |
| Total | $ 101,420 |

Total rental expense for all operating leases was approximately $3.91 million and $9.71 million for the three and nine months ended September 30, 2007, respectively, and $2.42 million and $7.01 million for the three and nine months ended September 30, 2006, respectively.

***Guarantees*** The Company occasionally enters into certain types of contracts that contingently require it to indemnify certain parties against third-party claims. The terms of these obligations vary and, because a maximum obligation is not explicitly stated, the Company has determined that it is not possible to make an estimate of the amount that it could be obligated to pay under such contracts.

Linsco provides guarantees to securities clearing houses and exchanges under their standard membership agreements, which require a member to guarantee the performance of other members. Under these agreements, if a member becomes unable to satisfy its obligations to the clearing houses and exchanges, all other members would be required to meet any shortfall. The Company's liability under these arrangements is not quantifiable and may exceed the cash and securities it has posted as collateral. However, the potential requirement for the Company to make payments under these agreements is remote. Accordingly, no liability has been recognized for these transactions.

***Litigation*** The Company has been named as a defendant in various legal actions, including arbitrations. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases in which claimants seek substantial or indeterminate damages, the Company cannot predict with certainty what the eventual loss or range of loss related to such matters will be. The Company believes, based on current knowledge, after consultation with counsel, and consideration of insurance, if any, that the outcome of such matters will not have a material adverse effect on the consolidated financial condition of the Company or its results of operations.

In November 2005, prior to the Company's acquisition of IASG, MSC received a "Wells" notice from the FINRA's Department of Enforcement. The staff alleged that MSC had failed to maintain adequate supervisory procedures regarding certain variable annuity transactions, and failed to maintain accurate books and records related thereto. On July 23, 2007, the staff filed a complaint against MSC and certain of its employees in connection with this matter. The Company has been indemnified for such claims and future settlements related to such matters by the prior owners.

***Regulatory*** In 2006, Linsco remediated certain transactions in conjunction with an Acceptance Waiver and Consent entered into with the FINRA in May 2005 regarding certain sales of Class B and Class C mutual fund shares (all of which had been accrued for in the prior years).

***Interest Rate and Loan Commitments*** The Company enters into written commitments to originate loans, whereby the interest rate on the loan is determined prior to funding; these commitments are referred to as interest rate lock commitments ("IRLCs"). IRLCs on loans are considered to be derivatives. As of September 30, 2007, the Company determined that the positive and negative fair value of these IRLCs was $13,524 and $12,947, respectively, on a committed principal total of $6.83 million.

IRLCs, as well as closed loans held for sale, expose the Company to interest rate risk. The Company manages this risk by entering into corresponding forward sales agreements with investors on a best-effort basis. The Company determined that such best-effort forward sales commitments meet the definition of a derivative. As of September 30, 2007, the Company determined the positive and negative fair value of the forward sales agreements was $21,861 and $21,650, respectively, on a committed principal total of $10.56 million.

Positive and negative increases to the fair value of IRLCs and forward sales agreements are recognized in other assets and accrued liabilities, with unrealized gains or losses recorded in other income.

***Representations and Warranties of Mortgage Loans*** In the ordinary course of business, the Company has a potential liability for representations and warranties made to purchasers and insurers of its mortgage loans, such as first payment defaults and return of premiums received in the event a loan is paid off within 120 days. Although loans are sold to investors on a nonrecourse basis, the Company may become liable for the unpaid principal and interest on defaulted loans or other loans if there has been a breach of representations or warranties. In such a case, the Company may be required to repurchase these loans with any subsequent loss on resale or foreclosure being borne by the Company. The Company did not repurchase any loans during the three and nine months ended September 30, 2007, and did not record a repurchase reserve at September 30, 2007.

***Other Commitments*** As of September 30, 2007, the Company had received collateral primarily in connection with customer margin loans with a market value of approximately $459.15 million, which it can sell or repledge. Of this amount, approximately $195.38 million has been pledged or sold as of September 30, 2007; $129.18 million was pledged to a bank in connection with an unutilized secured margin line of credit, $42.31 million was pledged to various clearing organizations, and $23.89 million was loaned to the DTC through participation in its Stock Borrow Program. As of December 31, 2006, the Company had received collateral primarily in connection with customer margin loans with a market value of approximately $404.19 million, which it can sell or repledge. Of this amount, approximately $150.52 million has been pledged or sold as of December 31, 2006: $100.38 million was pledged to a bank in connection with an unutilized secured margin line of credit, $35.26 million was pledged to various clearing organizations, and $14.88 million was loaned to the DTC through participation in its Stock Borrow Program.

Innovex sells its mortgage loans without recourse. It is usually required by the buyers (investors) of these loans to make certain representations concerning credit information, loan documentation, and collateral. It has not repurchased any loans during the three and nine months ended September 30, 2007 and 2006. As part of its brokerage operations, Innovex periodically enters into when-issued and delayed delivery transactions on behalf of its customers. Settlement of these transactions after September 30, 2007, did not have a material effect on the consolidated statements of financial condition of the Company.

In August of 2007, pursuant to agreements with a large global insurance company, Linsco began providing brokerage, clearing, and custody services on a fully disclosed basis; offering its investment advisory programs and platforms; and providing technology and additional processing and related services to its financial advisors and customers. The term of the agreements are five years, subject to additional 24-month extensions. Termination fees may be payable by a terminating or breaching party depending on the specific cause leading to termination.

**16. EMPLOYEE BENEFIT PLANS**

The Company has a 401(k) defined contribution plan. All employees meeting minimum age and length of service requirements are eligible to participate. The Company has an employer matching program whereby employer contributions are made to the 401(k) plan in an amount equal to 50% of the lesser of the amount designated by the employee for withholding and contribution to the 401(k) plan or 8% of the employee's total compensation. Effective January 1, 2007, the match was increased whereby employer contributions are made to the 401(k) plan in an amount equal to 50% of the lesser of the amount designated by the employee for withholding and contribution to the 401(k) plan or 10% of the employee's total compensation. The Company's total cost under the 401(k) plan was

$1.06 million and $2.77 million for the three and nine months ended September 30, 2007, respectively, and $390,000 and $1.34 million for the three and nine months ended September 30, 2006, respectively.

Certain IFAs, employees, and executive officers of IASG participate in deferred compensation plans. The plans permit certain IFAs and employees to defer portions of their compensation and earn interest on the deferred amounts. The interest rate is determined annually. Deferred compensation in the amount of $4.29 million as of September 30, 2007 is included in accounts payable and accrued liabilities.

Certain employees, officers, and directors also participate in stock option plans (the "Plans") of LPLIH (previously, Plans of LPLH). The Plans were assumed by and converted into Plans of LPLIH in conjunction with the Acquisition in Note 1 and provide for the granting of 3,349,437 incentive stock options, 199,264 nonqualified stock options, and an unspecified number of stock appreciation rights. Stock options granted under the Plans have an exercise period of 10 years and generally vest 33$^1/_3$% on the fifth anniversary of the grant date, and an additional 33$^1/_3$% on each of the sixth and seventh anniversaries of that date. Shares issued in conjunction with stock option exercises are issued from shares previously authorized, but not yet issued.

The Plans and the underlying option agreements also provide for accelerated vesting upon certain changes in control, including a public offering. The Acquisition qualified as a change in control event that triggered the acceleration provisions in the Plans. Immediately prior to that event and in accordance with the Plans, each employee's stock appreciation rights became fully vested and each employee's unvested stock options became 33$^1/_3$% vested. In conjunction with the Acquisition, certain employees elected to exercise their vested options or to convert them along with any unvested options into options for common shares of LPLIH, retaining the same terms and conditions of the original Plans. A total of 1,652,049 options were exercised and sold with the remaining 2,103,966 converted into 2,107,814 options of LPLIH. Additionally, all outstanding stock appreciation rights were exercised for which the former holders received a cash payment equal to the fair market value, as determined in the Acquisition, less the applicable exercise price and certain selling expenses. For the nine months ended September 30, 2007, the Company recognized compensation expense of $1.05 million related to the accelerated vesting of the stock options. All remaining unvested stock options vest on December 28, 2007.

The following table summarizes the Company's activity in Plans for the nine months ended September 30, 2007 and 2006:

| | Outstanding, Beginning of Period | Granted | Exercised | Forfeited | Outstanding, End of Period | Options Exercisable at End of Period |
|---|---|---|---|---|---|---|
| **Nine Months Ended September 30, 2007** | | | | | | |
| Options | 2,104,795 | 50,815 | (50) | | 2,155,560 | 1,151,315 |
| Weighted-average exercise price | $ 17.10 | $ 217.09 | $ 10.78 | $ | $ 21.81 | $ 16.52 |
| **Nine Months Ended September 30, 2006** | | | | | | |
| Options | 2,107,814 | 2,800 | (334) | (10,821) | 2,099,459 | 146,680 |
| Weighted-average exercise price | $ 16.45 | $ 103.19 | $ 23.83 | $ 16.99 | $ 16.55 | $ 17.11 |

The following table summarizes information about stock options outstanding:

| Range of Exercise Prices | Options Outstanding | Weighted-Average Remaining Life (Years) | Weighted-Average Exercise Price | Options Exercisable | Weighted-Average Exercise Price |
|---|---|---|---|---|---|
| At September 30, 2007: | | | | | |
| $10.77 $23.83 | 2,092,944 | 5.39 | $ 16.40 | 1,150,215 | $ 16.44 |
| $103.00 $189.00 | 24,201 | 9.21 | 165.42 | 1,100 | 103.10 |
| $216.00 $255.00 | 38,415 | 9.70 | 226.15 | | |
| | 2,155,560 | 5.51 | | 1,151,315 | $ 16.52 |
| At September 30, 2006: | | | | | |
| $10.77 $23.83 | 2,095,657 | 6.39 | $ 16.39 | 146,680 | $ 17.11 |
| $103.00 103.19 | 3,802 | 9.62 | 103.00 | | |
| | 2,099,459 | 6.40 | | 146,680 | $ 17.11 |

In November 2004, the Company had modified certain provisions of the stockholders' agreement underlying its stock options plan that significantly altered the original value of all outstanding employee stock options granted. For accounting purposes, this modification resulted in a new measurement date and additional compensation of $30.58 million, which is expensed over the original life of the awards. The Company recognizes this compensation according to the vesting schedule and for the three and nine months ended September 30, 2007 and 2006, has recorded approximately $349,000 and $1.05 million, and $680.000 and $2.14 million, respectively, in employee compensation and benefits in the accompanying consolidated statements of income with corresponding increases in additional paid-in capital. Approximately $349,000 remains in unrecognized compensation for those awards that are expected to be recognized ratably through December 31, 2007, their final vesting period. Cancellations or forfeitures will reduce these amounts.

The Company's IFAs participate in a stock bonus plan, which provides for the grant and allocation of up to 771,693 bonus credits. Each bonus credit represents the right to receive shares of common stock in the Company. Participation in the stock bonus plan is dependent upon meeting certain eligibility criteria, and shares are allocated to eligible participants based on certain performance metrics, including amount and type of commissions as well as tenure with the firm. Bonus credits vest annually in equal increments of $33^1/_3$% over a three-year period commencing in 2006 and expire on the 10th anniversary following the date of grant. Vested bonus credits convert into shares of common stock only upon the occurrence of a Company sale that constitutes a change in control or subsequent to an initial public offering. Unvested bonus credits held by IFAs who terminate prior to vesting will be forfeited and may be reallocated to other IFAs eligible under the plan. In conjunction with the transaction, each bonus credit was converted into a right to receive, on the same terms as conditions as previously applicable, bonus credits for common stock in the Company.

On January 1, 2006, 756,351 bonus credits were granted. For the year ended December 31, 2006, and the nine months ended September 30, 2007, the Company realized forfeitures with respect to 14,702 and 6,471 bonus credits, respectively, The Company reallocated 14,443 bonus credits during the nine months ended September 30, 2007. As of September 30, 2007, the Company had 749,621 bonus credits outstanding, 251,017 of which are vested.

**17. SEGMENT INFORMATION**

Under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* ("SFAS 131"), operating segments are defined as components of a company for which separate financial information is evaluated regularly by the chief operating decision marker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company classifies its operating segments based on services offered to its IFAs, which closely matches the Company's organization based on legal entities. The Company has identified five operating segments: Independent Financial Advisors, Trust Services, Mortgage Services, Insurance Services, and Affiliated Advisor Services.

The Independent Financial Advisors segment provides a full range of brokerage, investment advisory, and infrastructure services to IFAs and financial institutions that employ financial advisors in the United States. The other four business segments provide an advisory platform, trust, and related custodial services, mortgage brokerage and underwriting services, fixed insurance services, and a private-labeled investment advisory platform almost entirely to clients of IFAs of the Independent Financial Advisors segment. These other four business segments do not, individually or in the aggregate, meet the reporting requirements under SFAS 131 and consequently have been aggregated as "Other" for reporting purposes.

The accounting policies of the segments are the same as those described in Note 2, "Significant Accounting Policies." The Company evaluates the performance of its segments on a pretax basis, excluding items such as discontinued operations and extraordinary items. Intersegment revenues, defined as revenues from transactions with other segments within the Company, are not material and are therefore not disclosed.

Financial information for the Company's reportable segments is presented in the following table (in thousands):

| | Independent Financial Advisors | Other | Total Operating Segments | Corporate and Unallocated(a) | Consolidated Total |
|---|---|---|---|---|---|
| **Three months ended** | | | | | |
| September 30, 2007: | | | | | |
| Revenues | $ 721,349 | $ 7,981 | $ 729,330 | $ (4,313) | $ 725,017 |
| Interest expense | 133 | 50 | 183 | 30,857 | 31,040 |
| Depreciation and amortization | 7,608 | 84 | 7,692 | 12,951 | 20,643 |
| Income (loss) before income taxes | 63,059 | 677 | 63,736 | (45,524) | 18,212 |
| September 30, 2006: | | | | | |
| Revenues | 414,250 | 5,875 | 420,125 | 720 | 420,845 |
| Interest expense | 4 | 48 | 52 | 31,103 | 31,155 |
| Depreciation and amortization | 4,260 | 91 | 4,351 | 12,048 | 16,399 |
| Income (loss) before income taxes | 50,707 | 491 | 51,198 | (42,520) | 8,678 |
| **Nine months ended** | | | | | |
| September 30, 2007: | | | | | |
| Revenues | $ 1,921,838 | $ 23,235 | $ 1,945,073 | $ (9,454) | $ 1,935,619 |
| Interest expense | 211 | 239 | 450 | 92,353 | 92,803 |
| Depreciation and amortization | 19,503 | 263 | 19,766 | 37,035 | 56,801 |
| Income (loss) before income taxes | 223,320 | 2,195 | 225,515 | (133,129) | 92,386 |
| September 30, 2006: | | | | | |
| Revenues | 1,250,855 | 16,948 | | | |