STIFEL FINANCIAL CORP
Form 10-Q
November 06, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2018

OR

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: 001-09305

STIFEL FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

Delaware	43-1273600
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

501 N. Broadway, St. Louis, Missouri 63102-2188

(Address of principal executive offices and zip code)

(314) 342-2000

(Registrant’s telephone number, including area code)

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 (“the Exchange Act”) 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. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares outstanding of the registrant’s common stock, $0.15 par value per share, as of the close of business on November 1, 2018, was 72,011,806.

STIFEL FINANCIAL CORP.

Form 10-Q

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PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STIFEL FINANCIAL CORP.

Consolidated Statements of Financial Condition

(in thousands)	September 30, 2018 (Unaudited)	December 31, 2017
Assets		
Cash and cash equivalents	$694,302	$696,283
Cash segregated for regulatory purposes	21,585	90,802
Receivables:		
Brokerage clients, net	1,466,664	1,384,096
Brokers, dealers, and clearing organizations	646,120	459,107
Securities purchased under agreements to resell	622,361	512,220
Financial instruments owned, at fair value	1,162,732	1,143,684
Available-for-sale securities, at fair value	3,349,607	3,773,508
Held-to-maturity securities, at amortized cost	4,565,453	3,698,098
Loans held for sale, at lower of cost or market	262,063	226,068
Bank loans, net	8,253,989	6,947,759
Investments, at fair value	79,170	111,379
Fixed assets, net	297,846	155,120
Goodwill	1,025,714	968,834
Intangible assets, net	118,923	109,627
Loans and advances to financial advisors and other employees, net	383,477	378,124
Deferred tax assets, net	116,880	105,152
Other assets	693,162	624,092
Total Assets	$23,760,048	$21,383,953

See accompanying Notes to Consolidated Financial Statements.

STIFEL FINANCIAL CORP.

Consolidated Statements of Financial Condition (continued)

(in thousands, except share and per share amounts)	September 30, 2018 (Unaudited)	December 31, 2017
Liabilities and Shareholders' Equity		
Payables:		
Brokerage clients	$627,745	$828,206
Brokers, dealers, and clearing organizations	928,132	276,302
Drafts	91,639	107,043
Securities sold under agreements to repurchase	495,484	233,704
Bank deposits	14,502,952	13,411,935
Financial instruments sold, but not yet purchased, at fair value	911,374	778,863
Accrued compensation	379,453	493,973
Accounts payable and accrued expenses	374,456	308,911
Federal Home Loan Bank advances	1,064,000	745,000
Borrowings	140,030	256,000
Senior notes	1,015,714	1,014,940
Debentures to Stifel Financial Capital Trusts	67,500	67,500
Total liabilities	20,598,479	18,522,377
Shareholders' Equity:		
Preferred stock - $1 par value; authorized 3,000,000 shares; 6,000 shares issued	150,000	150,000
Common stock - $0.15 par value; authorized 97,000,000 shares; issued 74,441,001 and 71,636,986 shares, respectively	11,166	10,746
Additional paid-in-capital	1,873,232	1,733,348
Retained earnings	1,265,536	1,033,526
Accumulated other comprehensive loss	(59,389)	(26,736)
	3,240,545	2,900,884
Treasury stock, at cost, 1,435,882 and 772,302 shares, respectively	(78,976)	(39,308)
Total Shareholders' Equity	3,161,569	2,861,576
Total Liabilities and Shareholders' Equity	$23,760,048	$21,383,953

See accompanying Notes to Consolidated Financial Statements.

STIFEL FINANCIAL CORP.

Consolidated Statements of Operations

(Unaudited)

(in thousands, except per share amounts)	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Revenues:				
Commissions	$158,016	$162,612	$490,693	$510,150
Principal transactions	83,152	87,010	269,918	299,570
Investment banking	169,012	181,904	506,437	494,017
Asset management and service fees	200,743	179,848	596,112	515,501
Interest	169,760	117,862	461,915	327,766
Other income	6,127	9,558	18,557	25,508
Total revenues	786,810	738,794	2,343,632	2,172,512
Interest expense	48,468	17,625	112,200	50,165
Net revenues	738,342	721,169	2,231,432	2,122,347
Non-interest expenses:				
Compensation and benefits	422,324	448,410	1,322,387	1,338,673
Occupancy and equipment rental	54,035	57,427	165,226	167,864
Communications and office supplies	33,330	34,650	103,468	102,686
Commissions and floor brokerage	11,338	11,232	30,798	33,187
Other operating expenses	76,785	61,311	231,122	209,581
Total non-interest expenses	597,812	613,030	1,853,001	1,851,991
Income from operations before income tax expense	140,530	108,139	378,431	270,356
Provision for income taxes	36,672	41,603	98,525	85,497
Net income	103,858	66,536	279,906	184,859
Preferred dividends	2,343	2,343	7,031	7,031
Net income available to common shareholders	$101,515	$64,193	$272,875	$177,828
Earnings per common share:				
Basic	$1.41	$0.94	$3.80	$2.60
Diluted	$1.25	$0.79	$3.35	$2.21
Weighted-average number of common shares outstanding:				
Basic	71,919	68,522	71,824	68,488
Diluted	81,484	80,881	81,425	80,562
Cash dividends declared per common share	$0.12	$0.10	$0.36	$0.10

See accompanying Notes to Consolidated Financial Statements.

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STIFEL FINANCIAL CORP.

Consolidated Statements of Comprehensive Income

(Unaudited)

(in thousands)	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Net income	$103,858	$66,536	$279,906	$184,859
Other comprehensive income/(loss), net of tax: [1] [4]				
Changes in unrealized gains/(losses) on available-for-sale securities [2]	(3,138)	4,736	(28,065)	12,283
Amortization of losses of securities transferred to held-to-maturity from available-for-sale	—	439	—	1,348
Changes in unrealized gains/(losses) on cash flow hedging instruments [3]	(1,523)	183	1,895	698
Foreign currency translation adjustment	(1,336)	2,644	(3,434)	7,178
Total other comprehensive income/(loss), net of tax	(5,997)	8,002	(29,604)	21,507
Comprehensive income	$97,861	$74,538	$250,302	$206,366

[1] Net of tax benefit of $2.1 million and tax expense of $5.0 million for the three months ended September 30, 2018 and 2017, respectively. Net of tax benefit of $10.4 million and tax expense of $13.5 million for the nine months ended September 30, 2018 and 2017, respectively.

[2] There were no reclassifications to earnings during the three and nine months ended September 30, 2018 and 2017, respectively.

[3] Amounts are net of reclassifications to earnings of gains of $1.5 million and $0.7 million for the three months ended September 30, 2018 and 2017, respectively. Amounts are net of reclassifications to earnings of gains of $3.3 million and losses of $0.8 million for the nine months ended September 30, 2018 and 2017, respectively.

[4] The adoption of ASU 2018-02 on January 1, 2018 resulted in a reclassification of $3.0 million to retained earnings related to cash flow hedges and investment portfolio risk. The reclassification is reflected in the activity for the nine months ended September 30, 2018. See Note 2 for further details.

See accompanying Notes to Consolidated Financial Statements.

STIFEL FINANCIAL CORP.

Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)	Nine Months Ended September 30, 2018	2017
Cash Flows From Operating Activities:		
Net income	$279,906	$184,859
Adjustments to reconcile net income to net cash provided by/(used in) operating activities:		
Depreciation and amortization	20,503	26,976
Amortization of loans and advances to financial advisors and other employees	61,783	69,393
Amortization of premium on investment portfolio	18,714	11,248
Provision for loan losses and allowance for loans and advances to financial advisors and other employees	13,980	19,025
Amortization of intangible assets	8,741	9,092
Deferred income taxes	718	14,875
Stock-based compensation	75,382	81,613
(Gains)/losses on sale of investments	10,442	(2,888)
Other, net	(86,576)	2,377
Decrease/(increase) in operating assets, net of assets acquired:		
Receivables:		
Brokerage clients	(82,568)	125,905
Brokers, dealers, and clearing organizations	(187,013)	689,648
Securities purchased under agreements to resell	(110,141)	(209,747)
Financial instruments owned, including those pledged	(19,048)	(139,205)
Loans originated as held for sale	(1,099,187)	(1,152,654)
Proceeds from mortgages held for sale	1,051,789	1,194,709
Loans and advances to financial advisors and other employees	(67,872)	(46,699)
Other assets	31,543	(77,373)
Increase/(decrease) in operating liabilities, net of liabilities assumed:		
Payables:		
Brokerage clients	(200,461)	(94,594)
Brokers, dealers, and clearing organizations	180,463	63,554
Drafts	(15,404)	(17,089)
Financial instruments sold, but not yet purchased	132,511	50,291
Other liabilities and accrued expenses	(66,290)	91,896
Net cash provided by/(used in) operating activities	$(48,085)	$895,212

See accompanying Notes to Consolidated Financial Statements.

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STIFEL FINANCIAL CORP.

Consolidated Statements of Cash Flows (continued)

(Unaudited)

(in thousands)	Nine Months Ended September 30, 2018	2017
Cash Flows From Investing Activities:		
Proceeds from:		
Maturities and principal paydowns of available-for-sale securities	$763,982	$850,102
Calls and principal paydowns of held-to-maturity securities	443,295	193,140
Sale or maturity of investments	24,345	25,394
Increase in bank loans, net	(810,798)	(1,202,124)
Payments for:		
Purchase of available-for-sale securities	(331,657)	(1,350,033)
Purchase of held-to-maturity securities	(1,313,587)	(712,450)
Purchase of investments	(7,578)	(1,592)
Purchase of fixed assets	(18,271)	(21,153)
Acquisitions, net of cash received	599	(6,743)
Net cash used in investing activities	(1,249,670)	(2,225,459)
Cash Flows From Financing Activities:		
Repayments of borrowings, net	(257,197)	(299,000)
Proceeds from Federal Home Loan Bank advances, net	309,050	290,000
Payment of contingent consideration	(11,909)	(13,328)
Increase/(decrease) in securities sold under agreements to repurchase	261,780	(113,150)
Increase in bank deposits, net	590,000	1,356,478
Increase/(decrease) in securities loaned	471,367	(166,901)
Tax payments related to shares withheld for stock-based compensation plans	(39,815)	(76,242)
Proceeds from stock option exercises	2,278	—
Repurchase of common stock	(62,514)	(12,998)
Cash dividends on preferred stock	(7,031)	(7,031)
Cash dividends paid to common stock and equity-award holders	(26,023)	(6,835)
Net cash provided by financing activities	1,229,986	950,993
Effect of exchange rate changes on cash	(3,429)	7,178
Decrease in cash, cash equivalents, and cash segregated for regulatory purposes	(71,198)	(372,076)
Cash, cash equivalents, and cash segregated for regulatory purposes at beginning of period	787,085	986,167
Cash, cash equivalents, and cash segregated for regulatory purposes at end of period	$715,887	$614,091
Supplemental disclosure of cash flow information:		
Cash paid for income taxes, net of refunds	$27,280	$18,591
Cash paid for interest	111,832	49,901
Noncash financing activities:		
Unit grants, net of forfeitures	119,051	55,941
Issuance of common stock for acquisitions	110,671	9,352

The following presents cash, cash equivalents, and cash restricted for regulatory purposes for the periods presented (in thousands):

	September 30, 2018	December 31, 2017	September 30, 2017
Cash and cash equivalents	$ 694,302	$ 696,283	$ 588,916
Cash segregated for regulatory purposes	21,585	90,802	25,175
Total cash, cash equivalents, and cash segregated for regulatory purposes	$ 715,887	$ 787,085	$ 614,091

See accompanying Notes to Consolidated Financial Statements.

STIFEL FINANCIAL CORP.

Notes to Consolidated Financial Statements

(Unaudited)

NOTE 1 – Nature of Operations, Basis of Presentation, and Summary of Significant Accounting Policies

Nature of Operations

Stifel Financial Corp. (the “Company”), through its wholly owned subsidiaries, is principally engaged in retail brokerage; securities trading; investment banking; investment advisory; retail, consumer, and commercial banking; and related financial services. We have offices throughout the United States and Europe. Our major geographic area of concentration is throughout the United States, with a growing presence in the United Kingdom and Europe. Our company’s principal customers are individual investors, corporations, municipalities, and institutions.

On March 19, 2018, the Company completed the acquisition of Ziegler Wealth Management (“Ziegler”), a privately held investment bank, capital markets and proprietary investments firm that has 55 private client advisors in five states that manage approximately $5 billion in client assets. Ziegler provides its clients with capital raising, strategic advisory services, equity and fixed income sales & trading and research. The acquisition was funded with cash from operations. See Note 8 in the notes to consolidated financial statements for more details.

On August 31, 2018, the Company completed the acquisition of Business Bancshares, Inc. (“BBI”) and its wholly owned subsidiary, The Business Bank of St. Louis, a full-service banking facility with approximately $600.0 million in assets that operates from a single location. Upon the closing of the transaction, the Business Bank of St. Louis was renamed “Stifel Bank” and Business Bancshares, Inc. was renamed “Stifel Bancorp, Inc.” Stifel Bancorp, Inc. (“Stifel Bancorp”) is the holding company for Stifel Bank & Trust, Stifel Bank, and their wholly owned subsidiaries. We issued approximately 2.0 million shares for acquisition of BBI. See Note 8 in the notes to consolidated financial statements for more details.

Pro forma information is not presented, because the acquisition is not considered to be material, as defined by the SEC. The results of operations of Ziegler and Stifel Bancorp have been included in our results prospectively from the date of acquisition.

Basis of Presentation

The consolidated financial statements include Stifel Financial Corp. and its wholly owned subsidiaries, principally Stifel, Nicolaus & Company, Incorporated (“Stifel”), Keefe, Bruyette & Woods, Inc., and Stifel Bancorp. All material intercompany balances and transactions have been eliminated. Unless otherwise indicated, the terms “we,” “us,” “our,” or “our company” in this report refer to Stifel Financial Corp. and its wholly owned subsidiaries.

We have prepared the accompanying unaudited consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Pursuant to these rules and regulations, we have omitted certain information and footnote disclosures we normally include in our annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles. In management’s opinion, we have made all adjustments (consisting only of normal, recurring adjustments, except as otherwise noted) necessary to fairly present our financial position, results of operations and cash flows. Our interim period operating results do not necessarily indicate the results that may be expected for any other interim period or for the full fiscal year. These financial statements and accompanying notes should be read in conjunction with the consolidated financial statements and the notes thereto in our Annual Report on Form 10-K for the year ended December 31, 2017 on file with the SEC.

Certain amounts from prior periods have been reclassified to conform to the current period's presentation. The effect of these reclassifications on our company's previously reported consolidated financial statements was not material.

Summary of Significant Accounting Policies

For a detailed discussion about the Company's significant accounting policies, see Note 2, Summary of Significant Accounting Policies, in our consolidated financial statements included in Part II, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2017.

Other than the following, there were no significant changes made to the Company's significant accounting policies. The accounting policy changes are attributable to the adoption of the Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (the "new revenue standard" or "ASU 2014-09") on January 1, 2018. These revenue recognition policy updates are applied prospectively in our consolidated financial statements from January 1, 2018. Reported financial information for the historical comparable period was not revised and continues to be reported under the accounting standards in effect during the historical periods.

The new revenue standard primarily impacts the following revenue recognition and presentation accounting policies of our company:

Investment Banking Revenues

Advisory fees from mergers and acquisitions engagements are recognized at a point in time when the related transaction is completed, as the performance obligation is to successfully broker a specific transaction.

Advisory expenses are deferred only to the extent they are explicitly reimbursable by the client and the related revenue is recognized at a point in time. All other investment banking advisory related expenses are expensed as incurred.

Underwriting expenses are recognized as non-interest expense in the consolidated statements of operations and any expense reimbursements are recognized as investment banking revenues. See Note 2, New Accounting Pronouncements, and Note 17, Revenues from Contracts with Customers, for further information.

NOTE 2 – New Accounting Pronouncements

Recently Adopted Accounting Guidance

Comprehensive Income

In February 2018, the FASB issued ASU 2018-02, "Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income" that provides for the reclassification from accumulated other comprehensive income to retained earnings for stranded effects resulting from the Tax Cuts and Jobs Act of 2017. The accounting update is effective for fiscal years beginning after December 15, 2018 and early adoption is permitted. We early adopted the guidance in the update on January 1, 2018. The adoption of the accounting update resulted in a reclassification adjustment of $3.0 million related to cash flow hedges and investment portfolio credit risk in our consolidated financial statements.

Statement of Cash Flows

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230) – Restricted Cash," which adds or clarifies guidance on the classification and presentation of restricted cash in the statement of cash flows. The accounting update is effective for fiscal years beginning after December 15, 2017. We adopted the guidance in the update on January 1, 2018. The adoption of the accounting update did not have a material impact on our consolidated statement of cash flows. Upon adoption of the accounting update, we recorded a decrease of $48.1 million in net cash provided by operating activities for the nine months ended September 30, 2017 related to reclassifying the changes in our cash segregated for regulatory purposes and restricted cash balance from operating activities to the cash and cash equivalent balances within the consolidated statements of cash flows.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230) – Classification of Certain Cash Receipts and Cash Payments," which amends and clarifies the current guidance to reduce diversity in practice of the classification of certain cash receipts and payments in the consolidated statements of cash flows. The accounting update is effective for fiscal years beginning after December 31, 2017. We adopted the guidance in the update on January 1, 2018. The adoption of the accounting update did not have a material impact on our consolidated statements of cash flows.

Financial Assets and Financial Liabilities

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities" that will change the income statement impact of equity investments held by an entity, and the recognition of changes in fair value of financial liabilities when the fair value option is elected. The accounting update also amends certain disclosure requirements associated with the fair value of financial instruments. The accounting update is effective for fiscal years beginning after December 15, 2017. We adopted the guidance in the update on January 1, 2018. The adoption of the accounting update did not have a material impact on our consolidated financial statements.

Revenue Recognition

Effective January 1, 2018, the Company adopted ASU 2014-09, which provides accounting guidance on the recognition of revenues from contracts and requires gross presentation of certain costs that were previously offset against revenue. This change was applied prospectively from January 1, 2018 and there is no impact on our previously presented results. The adoption of the new revenue standard resulted in a reduction of beginning retained earnings of $3.9 million after-tax as a cumulative effect of adoption of an accounting change.

The impact of adoption is primarily related to investment banking revenues that were previously recognized in prior periods, which are now being deferred under the new revenue standard.

With the adoption of the new revenue recognition standard on January 1, 2018, capital raising and advisory fee revenues are no longer presented net of the related out-of-pocket deal expenses. As a result, capital raising and advisory fee revenues and other operating expenses are higher in the first nine months of 2018 by an identical $25.9 million, with no impact to net income.

The scope of the accounting update does not apply to revenue associated with financial instruments, and as a result, will not have an impact on the elements of our consolidated statements of operations most closely associated with financial instruments, including principal transaction revenues, interest income, and interest expense.

The new revenue standard primarily impacts the following revenue recognition and presentation accounting policies:

Advisory fees from mergers and acquisitions engagements are recognized at a point in time when the related transaction is completed, as the performance obligation is to successfully broker a specific transaction.

Advisory expenses had historically been deferred until reimbursed by the client, the related fee revenue was recognized or the engagement was otherwise concluded. Under the new revenue standard, expenses are deferred only to the extent they are explicitly reimbursable by the client and the related revenue has been recognized. All other investment banking advisory related expenses, including expenses incurred related to restructuring assignments, are expensed as incurred.

Underwriting expenses had historically been recorded net of client reimbursements and/or netted against revenues. Under the new revenue standard, all investment banking expenses will be recognized as non-interest expense in the consolidated statements of operations and any expense reimbursements will be recognized as investment banking revenues (i.e., expenses are no longer recorded net of client reimbursements and are not netted against revenues).

Recently Issued Accounting Guidance

Derivatives and Hedging

In August 2017, the FASB issued ASU 2017-12, “Derivatives and Hedging (Topic 815) – Targeted Improvements to Accounting for Hedging Activities,” which amends the hedge accounting recognition and presentation requirements. The accounting update improves the transparency and understandability of information conveyed to financial statement users by better aligning companies’ hedging relationship to their existing risk management strategies, simplifies the application of hedge accounting and increases transparency regarding the scope and results of hedging program. The accounting update is effective for fiscal years beginning after December 15, 2018 (January 1, 2019 for our company) and early adoption is permitted. We are currently evaluating the impact of the accounting update, but the adoption is not expected to have a material impact on our consolidated financial statements.

Callable Debt Securities

In March 2017, the FASB issued ASU 2017-08, “Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities,” which shortens the amortization period for the premium on certain callable debt securities to the earliest call date. The amendments are applicable to any purchased individual debt security with an explicit and non-contingent call feature that is callable at a fixed price on a preset date. The accounting update is effective for fiscal years beginning after December 15, 2018 (January 1, 2019 for our company) under a modified retrospective approach and early adoption is permitted. We are evaluating the impact the adoption of this new guidance will have on our consolidated financial statements.

Goodwill Impairment Testing

In January 2017, the FASB issued ASU 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment,” which simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test. Under the accounting update, the annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount, and an impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The accounting update is effective for annual or any interim impairment tests in fiscal years beginning after December 15, 2019 (January 1, 2020 for our company) and early adoption is permitted. We are currently evaluating the impact of the accounting update, but the adoption is not expected to have a material impact on our consolidated financial statements.

Financial Instruments – Credit Losses

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." This accounting update impacts the impairment model for certain financial assets measured at amortized cost by requiring a current expected credit loss ("CECL") methodology to estimate expected credit losses over the entire life of the financial asset, recorded at inception or purchase. CECL will replace the loss model currently applicable to bank loans, held-to-maturity securities, and other receivables carried at amortized cost.

The accounting update also eliminates the concept of other-than-temporary impairment for available-for-sale securities. Impairments on available-for-sale securities will be required to be recognized in earnings through an allowance, when the fair value is less than amortized cost and a credit loss exists or the securities are expected to be sold before recovery of amortized cost. Under the accounting update, there may be an ability to determine there are no expected credit losses in certain circumstances, e.g., based on collateral arrangements for lending and financing transactions or based on the credit quality of the borrower or issuer.

Overall, the amendments in this accounting update are expected to accelerate the recognition of credit losses for portfolios where CECL models will be applied. The accounting update is effective for fiscal years beginning after December 15, 2019 (January 1, 2020 for our company) with early adoption permitted as of January 1, 2019. We are currently evaluating the impact of the accounting update, but the adoption is not expected to have a material impact on our consolidated financial statements.

Leases

In February 2016, the FASB issued ASU 2016-02, “Leases – (Topic 842)” that requires for leases longer than one year, a lessee recognize in the statements of financial condition a right-of-use asset, representing the right to use the underlying asset for the lease term, and a lease liability, representing the liability to make lease payments. The accounting update also requires that for finance leases, a lessee recognize interest expense on the lease liability, separately from the amortization of the right-of-use asset in the statements of earnings, while for operating leases, such amounts should be recognized as a combined expense. In addition, this accounting update requires expanded disclosures about the nature and terms of lease agreements.

The accounting update is effective for fiscal years beginning after December 15, 2018 (January 1, 2019 for our company) under a modified retrospective approach and early adoption is permitted. The Company’s implementation efforts include reviewing existing leases and service contracts, which may include embedded leases. Upon adoption, our company expects a gross up on its consolidated statements of financial condition upon recognition of the right-of-use assets and lease liabilities and does not expect the amount of the gross up to have a material impact on its financial condition.

NOTE 3 – Receivables From and Payables to Brokers, Dealers, and Clearing Organizations

Amounts receivable from brokers, dealers, and clearing organizations at September 30, 2018 and December 31, 2017, included (in thousands):

	September 30, 2018	December 31, 2017
Receivables from clearing organizations	$ 440,154	$ 270,285
Deposits paid for securities borrowed	170,165	132,776
Securities failed to deliver	35,801	56,046
	$ 646,120	$ 459,107

Amounts payable to brokers, dealers, and clearing organizations at September 30, 2018 and December 31, 2017, included (in thousands):

	September 30, 2018	December 31, 2017
Deposits received from securities loaned	$ 691,150	$ 219,782
Payable to clearing organizations	201,510	27,223
Securities failed to receive	35,472	29,297
	$ 928,132	$ 276,302

Deposits paid for securities borrowed approximate the market value of the securities. Securities failed to deliver and receive represent the contract value of securities that have not been delivered or received on settlement date.

NOTE 4 – Fair Value Measurements

We measure certain financial assets and liabilities at fair value on a recurring basis, including financial instruments owned, available-for-sale securities, investments, financial instruments sold, but not yet purchased, and derivatives.

We generally utilize third-party pricing services to value Level 1 and Level 2 available-for-sale investment securities, as well as certain derivatives designated as cash flow hedges. We review the methodologies and assumptions used by the third-party pricing services and evaluate the values provided, principally by comparison with other available market quotes for similar instruments and/or analysis based on internal models using available third-party market data. We may occasionally adjust certain values provided by the third-party pricing service when we believe, as the result of our review, that the adjusted price most appropriately reflects the fair value of the particular security.

Following are descriptions of the valuation methodologies and key inputs used to measure financial assets and liabilities recorded at fair value. The descriptions include an indication of the level of the fair value hierarchy in which the assets or liabilities are classified.

Financial Instruments Owned and Available-For-Sale Securities

When available, the fair value of financial instruments is based on quoted prices in active markets and reported in Level 1. Level 1 financial instruments include highly liquid instruments with quoted prices, such as equity securities listed in active markets, corporate fixed income securities, U.S. government securities, and U.S. government agency securities.

If quoted prices are not available for identical instruments, fair values are obtained from pricing services, broker quotes, or other model-based valuation techniques with observable inputs, such as the present value of estimated cash flows, and reported as Level 2. The nature of these financial instruments include instruments for which quoted prices are available but traded less frequently, instruments whose fair value has been derived using a model where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data, and instruments that are fair valued using other financial instruments, the parameters of which can be directly observed. Level 2 financial instruments include U.S. government agency securities, mortgage-backed securities, corporate fixed income and equity securities infrequently traded, state and municipal securities, sovereign debt, and asset-backed securities, which primarily include collateralized loan obligations.

We have identified Level 3 financial instruments to include certain equity securities with unobservable pricing inputs and certain non-agency mortgage-backed securities. Level 3 financial instruments have little to no pricing observability as of the report date. These financial instruments do not have active two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

Investments

Investments carried at fair value primarily include corporate equity securities, auction-rate securities ("ARS"), and private company investments.

Corporate equity securities are valued based on quoted prices in active markets and reported in Level 1. No securities with unobservable pricing inputs are reported in Level 3.

ARS are valued based upon our expectations of issuer redemptions and using internal discounted cash flow models that utilize unobservable inputs. ARS are reported as Level 3 assets.

Direct investments in private companies, reported as Level 3 assets, may be valued using the market approach and were valued based on an assessment of each underlying investment, incorporating evaluation of additional significant third-party financing, changes in valuations of comparable peer companies, the business environment of the companies, market indices, assumptions relating to appropriate risk adjustments for nonperformance, and legal restrictions on disposition, among other factors. The fair value derived from the methods used are evaluated and weighted, as appropriate, considering the reasonableness of the range of values indicated. Under the market approach, fair value may be determined by reference to multiples of market-comparable companies or transactions, including earnings before interest, taxes, depreciation, and amortization ("EBITDA") multiples. For securities utilizing the market comparable companies valuation technique, a significant increase (decrease) in the EBITDA multiple in isolation could result in a significantly higher (lower) fair value measurement.

Investments in Funds That Are Measured at Net Asset Value Per Share

The Company's investments in funds measured at NAV include private company investments, partnership interests, mutual funds, private equity funds, and money market funds. Private equity funds primarily invest in a broad range of industries worldwide in a variety of situations, including leveraged buyouts, recapitalizations, growth investments and distressed investments. The private equity funds are primarily closed-end funds in which the Company's investments are generally not eligible for redemption. Distributions will be received from these funds as the underlying assets are liquidated or distributed.

The general and limited partnership interests in investment partnerships were primarily valued based upon NAVs received from third-party fund managers. The various partnerships are investment companies, which record their underlying investments at fair value based on fair value policies established by management of the underlying fund. Fair value policies at the underlying fund generally require the funds to utilize pricing/valuation information, including independent appraisals, from third-party sources. However, in some instances, current valuation information for illiquid securities or securities in markets that are not active may not be available from any third-party source or fund management may conclude that the valuations that are available from third-party sources are not reliable. In these instances, fund management may perform model-based analytical valuations that may be used as an input to value these investments.

The tables below present the fair value of our investments in, and unfunded commitments to, funds that are measured at NAV (in thousands):

	September 30, 2018	
	Fair value of investments	Unfunded commitments
Money market funds	$18,696	$ —
Mutual funds	10,506	—
Private equity funds	3,394	1,535
Partnership interests	4,405	1,324
Total	$37,001	$ 2,859

	December 31, 2017	
	Fair value of investments	Unfunded commitments
Money market funds	$77,441	$ —
Mutual funds	11,748	—
Private equity funds	7,677	1,825
Partnership interests	5,124	1,330
Total	$101,990	$ 3,155

Financial Instruments Sold, But Not Yet Purchased

Financial instruments sold, but not purchased, recorded at fair value based on quoted prices in active markets and other observable market data include highly liquid instruments with quoted prices, such as U.S. government securities, corporate fixed income securities, and equity securities listed in active markets, which are reported as Level 1.

If quoted prices are not available, fair values are obtained from pricing services, broker quotes, or other model-based valuation techniques with observable inputs, such as the present value of estimated cash flows, and reported as Level 2. The nature of these financial instruments include instruments for which quoted prices are available but traded less frequently, instruments whose fair value has been derived using a model where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data, and instruments that are fair valued using other financial instruments, the parameters of which can be directly observed. Level 2 financial instruments include U.S. government agency securities, mortgage-backed securities not actively traded, corporate fixed income securities, and sovereign debt.

Derivatives

Derivatives are valued using quoted market prices for identical instruments when available or pricing models based on the net present value of estimated future cash flows. The valuation models used require market observable inputs, including contractual terms, market prices, yield curves, credit curves, and measures of volatility. We manage credit risk for our derivative positions on a counterparty-by-counterparty basis and calculate credit valuation adjustments, included in the fair value of these instruments, on the basis of our relationships at the counterparty portfolio/master netting agreement level. These credit valuation adjustments are determined by applying a credit spread for the counterparty to the total expected exposure of the derivative after considering collateral and other master netting arrangements. We have classified our interest rate swaps as Level 2.

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Assets and liabilities measured at fair value on a recurring basis as of September 30, 2018, are presented below (in thousands):

	September 30, 2018			
	Total	Level 1	Level 2	Level 3
Financial instruments owned:				
U.S. government securities	$36,214	$36,214	$—	$—
U.S. government agency securities	167,886	—	167,886	—
Mortgage-backed securities:				
Agency	380,044	—	380,044	—
Non-agency	23,747	—	23,746	1
Asset-backed securities	29,806	—	29,451	355
Corporate securities:				
Fixed income securities	290,627	262	290,365	—
Equity securities	69,205	68,892	212	101
Sovereign debt	15,996	—	15,996	—
State and municipal securities	149,207	—	149,207	—
Total financial instruments owned	1,162,732	105,368	1,056,907	457
Available-for-sale securities:				
U.S. government agency securities	5,165	516	4,649	—
State and municipal securities	68,876	—	68,876	—
Mortgage-backed securities:				
Agency	250,808	—	250,808	—
Commercial	68,823	—	68,823	—
Non-agency	1,269	—	1,269	—
Corporate fixed income securities	1,177,315	—	1,177,315	—
Asset-backed securities	1,777,351	—	1,777,351	—
Total available-for-sale securities	3,349,607	516	3,349,091	—
Investments:				
Corporate equity securities	42,495	42,495	—	—
Auction rate securities:				
Equity securities	16,525	—	—	16,525
Municipal securities	799	—	—	799
Other	1,046	—	189	857
Investments in funds measured at NAV	18,305			
Total investments	79,170	42,495	189	18,181
Cash equivalents measured at NAV	18,696			
Derivative contracts [1]	11,117		11,117	
	$4,621,322	$148,379	$4,417,304	$18,638

[1] Included in other assets in the consolidated statements of financial condition.

September 30, 2018

	Total	Level 1	Level 2	Level 3
Liabilities:				
Financial instruments sold, but not yet purchased:				
U.S. government securities	$512,275	$512,275	$—	$ —
Mortgage-backed securities:				
Agency	95,312	—	95,312	