

# Statement Of Financial Condition

As Of September 30, 2016 (UNAUDITED)

## RED CAPITAL MARKETS, LLC

STATEMENT OF FINANCIAL CONDITION, SEPTEMBER 30, 2016 (UNAUDITED)

### ASSETS

Cash and cash equivalents	\$ 21,176,343
Restricted cash	628,636
Remarketing agent receivables	155,410
Derivative assets (note 8)	3,604,946
Intangible assets, net (note 11)	403,802
Other assets, net	<u>526,914</u>
 TOTAL ASSETS	 <u><u>\$ 26,496,051</u></u>

### LIABILITIES AND SHAREHOLDER'S EQUITY

LIABILITIES	
Accrued compensation	\$ 826,505
Lines of credit (note 5)	42,975
Lines of credit-affiliate (note 5)	4,964,624
Derivative liabilities (note 8)	2,350,910
Accounts payable and accrued expenses	19,170
Accounts payable-affiliate	238,086
Deferred application fees and borrower deposits	551,295
Other liabilities	<u>453,985</u>
 Total liabilities	 <u>9,447,550</u>
Commitments and indemnifications (note 9)	
SHAREHOLDER'S EQUITY	
Paid-in capital	10,486,633
Retained earnings	<u>6,561,868</u>
Total shareholder's equity	<u>17,048,501</u>
 TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	 <u><u>\$ 26,496,051</u></u>

See accompanying notes to Statement of Financial Condition

# NOTES TO STATEMENT OF FINANCIAL CONDITION SEPTEMBER 30, 2016 (UNAUDITED)

## (1) ORGANIZATION

Red Capital Markets, LLC (the Company) is a wholly owned subsidiary of Red Capital Group, LLC (the Shareholder), which was purchased effective on May 1, 2010 by a group of investors (the Acquisition), led by ORIX USA Corporation (ORIX USA), which is a majority owned subsidiary of ORIX Corporation (ORIX). Effective in February 2016, the Shareholder became a wholly owned subsidiary of ORIX USA.

The Company's primary businesses are the underwriting of taxable and tax-exempt bonds and the sale and secondary trading of taxable and tax-exempt bonds and taxable mortgage-backed securities. The Company has locations in Columbus, OH, Westport, CT, Reston, VA, and San Diego, CA.

The Company is registered as a securities broker and dealer pursuant to the Securities Act of 1934 and is a member of the Financial Industry Regulatory Authority. The Company conducts substantially all business through its primary clearing broker Pershing LLC (Pershing).

## (2) SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make certain estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

The Company's accounting policies, which significantly affect the accompanying financial statement, are as follows:

### (A) CASH, CASH EQUIVALENTS AND RESTRICTED CASH

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. The Company had no cash equivalents as of September 30, 2016.

Restricted cash consists of Good Faith Deposits held on behalf of customers as well as a deposit held at Pershing pursuant to the custodial agreement.

### (B) SECURITIES INVENTORY

Securities inventory is carried at its fair value, determined by an independent valuation or by management by considering the value of similar securities and by considering such factors as call protection, interest rates, and time to maturity. Changes in fair value of such securities are reflected in the Statement of Operations as part of Net Trading Gains for trading securities and Other Comprehensive Income for Available-for-Sale securities. Gains and losses on sales of securities are computed using the cost of the specific security sold. Security transactions for all regular-way trades are recorded within Securities Inventory on a trade date basis. Security transactions for all other trades are recorded as Derivative Assets and Liabilities until date of settlement.

### (C) FINANCIAL INSTRUMENTS

The Company considers cash and cash equivalents, customer and other receivables, other payables and other short term borrowings as financial instruments. Given the short term nature of these assets and liabilities, the respective amounts recorded in the Statement of Financial Condition approximate fair value.

### (D) FIXED ASSETS

Fixed assets primarily consist of furniture and equipment. Fixed assets owned by the Company are stated at cost less accumulated depreciation and amortization, which is computed using the straight-line method over the estimated useful lives of the assets for financial statement purposes, ranging from three to ten years and accelerated methods for tax reporting. At September 30, 2016, fixed asset accumulated depreciation and amortization was \$54,660.

## (E) DERIVATIVE INSTRUMENTS

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 815, Derivative Instruments and Hedging, requires all derivative instruments to be carried at fair value on the Statement of Financial Condition. The Company uses derivative instruments primarily to protect against the risk of adverse interest rate movements. The Company's derivative financial instruments include forward commitments to buy and sell taxable mortgage backed securities. These derivative instruments are not designated in an ASC Topic 815 hedge relationship. All changes in the fair value of derivatives are recognized immediately in earnings. See additional discussion of derivative instruments in note 8.

## (F) CUSTOMER ACCOUNTS

In accordance with Securities Exchange Commission Rule 15c3-3, the Company had no requirement to hold a balance at September 30, 2016 in a special reserve account for the exclusive benefit of institutional customers.

## (G) ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

The Company adopted the provisions of FASB ASC 740 10 Income Taxes – Accounting for Uncertainty in Income Taxes. In accordance with the provisions of this standard, the Company has evaluated the tax positions taken or expected to be taken to determine whether the tax positions are "more likely than not" of being sustained by applicable tax authorities. Tax positions deemed to meet the more likely than not threshold would be recorded as a tax benefit or expense in the current year. See additional discussion of income taxes in note 7.

## (H) RECENT ACCOUNTING PRONOUNCEMENTS

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842), was issued. ASU 2016-02 represents a significant reform to the accounting for leases. Lessees initially recognize a lease liability for the obligation to make lease payments and a right-of-use ("ROU") asset for the right to use the underlying asset for the lease term. The lease liability is measured at the present value of the lease payments over the lease term. The ROU asset is measured at the lease liability amount, adjusted for lease prepayments, lease incentives received and the lessee's initial direct costs. Lessees can make an accounting policy election, by class of underlying asset, to not recognize ROU assets and lease liabilities for leases with a lease term of 12 months or less as long as the leases do not include options to purchase the underlying assets that the lessee is reasonably certain to exercise.

In addition to the changes affecting entities' balance sheets, ASU 2016-02 includes guidance that makes minor changes to the way the expense is recorded. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. ASU 2016-02 is effective for us April 1, 2019. We are still in the process of determining the significance of the impact ASU 2016-02 will have on our financial statements and operations.

In January 2016, ASU 2016-01, Financial Instruments – Overall – Recognition and Measurement of Financial Assets and Financial Liabilities, was issued. The guidance requires that unconsolidated equity investments not accounted for under the equity method be recorded at fair value, with changes in fair value recorded through net income. The accounting principles that permitted available-for-sale classification with unrealized holding gains and losses recorded in other comprehensive income for equity securities will no longer be applicable. The guidance is not applicable to debt securities and loans and requires minor changes to the disclosure and presentation of financial instruments. The effective date of ASU 2016-01 for us is April 1, 2018. We are still in the process of determining the significance of the impact that ASU 2016-01 will have on our financial statements and operations.

### (3) FAIR VALUE MEASUREMENTS

Effective with the adoption of FASB ASC Topic 820, Fair Value Measurements and Disclosures (ASC Topic 820) the Company determines the fair value of its financial instruments based on the fair value hierarchy established in that standard, which requires an entity to maximize the use of quoted price and observable inputs and to minimize the use of unobservable inputs when measuring fair value. Various valuation techniques are utilized, depending on the nature of the financial instrument, including the use of market prices for identical instruments and market prices for similar instruments. When possible, active and observable market data for identical or similar financial instruments are utilized. Alternatively, fair value is determined using assumptions that management believes a market participant would use in pricing the asset or liability.

ASC Topic 820 creates a three level hierarchy under which individual fair value estimates are to be ranked based on the relative reliability of the inputs used in the valuation. This hierarchy is the basis for the disclosure requirements, with fair value estimates based on the least reliable inputs requiring more extensive disclosures about the valuation method used and the gains and losses associated with those estimates. Level 1 assets and liabilities are measured using observable or quoted market prices for identical instruments in active markets. Level 2 assets and liabilities are measured using observable inputs other than quoted prices in active markets. Level 3 assets and liabilities are measured using significant unobservable inputs and significant management assumptions. The fair value of securities held by the Company is generally based on significant observable inputs including prices of similar assets which results in those securities being considered Level 2 in the ASC Topic 820 hierarchy.

A summary of assets and liabilities at September 30, 2016 that the Company measures at fair value is presented below:

	Level 1	Level 2	Level 3	Total
Assets:				
Derivative assets	—	3,604,946	—	3,604,946
Total	\$ —	3,604,946	—	3,604,946
Liabilities:				
Derivative liabilities	\$ —	2,350,910	—	2,350,910
Total	\$ —	2,350,910	—	2,350,910

There were no transfers between Level 1 and Level 2 during the period.

### (4) SECURITIES INVENTORY

The Company had no securities inventory at September 30, 2016.

### (5) LINES OF CREDIT

The Company has a revolving promissory demand note from ORIX USA that it uses to fund its operations. Under terms of the note, the Company may borrow up to \$50,000,000 at an interest rate equal to the LIBOR Index Monthly rate plus 15 basis points. At September 30, 2016, the Company had borrowings outstanding under this note of \$4,955,368 and accrued interest payable of \$9,256.

The Company has a debt agreement from Pershing that it uses to fund its trading activity. Under terms of the agreement, the Company may borrow up to the house margin requirement based on its securities inventory established on a daily basis by Pershing at an interest rate equal to the Pershing daily cost of funds, as defined, plus 75 basis points. At September 30, 2016, the Company did not have borrowings outstanding under this agreement but had accrued interest payable of \$42,975.

### (6) NET CAPITAL REQUIREMENTS

The Company is subject to the uniform net capital rule 15c3-1 (Rule) of the Securities Exchange Commission. Under the Rule, the Company is required to maintain minimum net capital of \$250,000, and aggregate indebtedness cannot exceed a ratio of 15 to 1. The Company's net capital and excess net capital calculated in accordance with the Rule at September 30, 2016 was \$14,979,946 and \$14,506,836, respectively. The ratio of aggregate indebtedness to net capital as calculated in accordance with the Rule was 0.47 to 1 at September 30, 2016.

### (7) INCOME TAXES

The Company has been structured to qualify as a pass through entity not required to pay income tax at the state or federal level. The Shareholder intends that the Company be treated as a disregarded entity for all federal and state income tax purposes.

Management has evaluated the Company's tax positions and concluded that the Company had taken no uncertain tax positions that require adjustment to the financial statements. All tax years between 2011 and 2015 are open to federal tax examination subject to the federal statute of limitations.

### (8) DERIVATIVE INSTRUMENTS

As part of its business of trading taxable mortgage backed securities, the Company's risk management strategy includes executing forward commitments to sell taxable mortgage backed securities to unaffiliated counterparties. Simultaneously with the execution of these forward commitments, the Company enters into an agreement with an affiliate to acquire the mortgage backed security specified in the forward sales commitment. Concurrent with the Company's execution of the forward commitment and its agreement with the affiliate, the affiliate has a loan commitment with a borrower. In addition, the Company's risk management strategy also includes executing forward purchase commitments to acquire taxable mortgage backed securities from unaffiliated counterparties.

The forward sale commitments, treated as derivatives under ASC Topic 815 are used to economically hedge changes in fair value of the commitment to purchase the same mortgage backed security that may occur due to movements in interest rates.

The Company values derivatives at fair value.

#### *Fair Values of Derivative Instruments as of September 30, 2016*

DERIVATIVE ASSETS		
Derivatives not accounted for as hedging instruments	Statement of financial condition location	Fair value
Forward commitments	Derivatives assets	\$ 3,604,946
Total		\$ 3,604,946
DERIVATIVE LIABILITIES		
Derivatives not accounted for as hedging instruments	Statement of financial condition location	Fair value
Forward commitments	Derivatives liabilities	\$ 2,350,910
Total		\$ 2,350,910

At September 30, 2016, the Company had mandatory commitments to deliver \$150,994 of fixed and variable rate mortgage backed securities and written commitments to purchase \$150,994 of the same securities from its affiliate, respectively. In addition, the Company had written commitments to deliver \$132,720,819 of fixed rate mortgage backed securities and written commitments to purchase \$132,720,819 of the same securities from unaffiliated counterparties at September 30, 2016.

### (9) CONTINGENCIES AND INDEMNIFICATIONS

Liabilities for loss contingencies arising from claims, assessments, litigation, fines, and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount can be reasonably estimated. Legal costs incurred in connection with loss contingencies are expensed as incurred. The Company provides representations and warranties to counterparties in connection with a variety of commercial transactions and occasionally indemnifies them against potential losses caused by the breach of those representations and warranties. These indemnifications generally are standard contractual terms and are entered into in the normal course of business. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these arrangements and has not recorded any liability in the financial statements for any contingencies or indemnifications.

## (10) BENEFIT PLAN

The Company participates in the ORIX USA Corporation Savings and Investment Plan. Substantially all employees are eligible to contribute a portion of their pretax compensation to this defined contribution plan. ORIX USA may make contributions to the plan for employees the first month following the date of hire in the form of a 50% match of each dollar contributed on the first 12.5% of pay.

## (11) PURCHASED REMARKETING AGENT AGREEMENTS

On May 1, 2010, as part of the Acquisition, the Company recognized identifiable intangible assets related to its rights to serve as remarketing agent for certain tax exempt issues of variable rate demand notes (VRDN). Under the terms of the remarketing agreements, an investor in the VRDN may put the note back to the Company under certain conditions in which case the Company would remarket the note to another investor. If the Company is unable to successfully remarket the VRDN, the VRDN is sent back to the Trustee.

These contracts were measured at their acquisition date fair value of \$2,141,000. The value for these rights is amortized based on its expected useful life of nine years using the straight line method.

At September 30, 2016, accumulated amortization of the agreements was \$1,411,902.

## (12) RELATED PARTY TRANSACTIONS

The Company is a party to an Expense Sharing Agreement with an affiliate, Red Mortgage Capital, LLC (RMC). This agreement covers expenses paid by RMC and reimbursed by the Company, based on allocation percentages determined per the agreement. The Company is also party to a shared services agreement with ORIX USA. This agreement covers expenses paid by ORIX USA and reimbursed by the Company based on allocation percentages determined per the agreement.

## (13) SUBSEQUENT EVENTS

The Company has evaluated events and transactions for recognition and disclosure and determined there are no items to disclose.

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### Securities Investor Protection Corporation (SIPC)

RED Capital Markets, LLC is a member of the Securities Investor Protection Corporation (SIPC). Information about SIPC, including an explanatory brochure, is available at [www.sipc.org](http://www.sipc.org) or by calling 202-371-8300.

### Member FINRA

RED Capital Markets, LLC is a member of the Financial Industry Regulatory Authority (FINRA).

You may obtain information about FINRA as well as access FINRA's BrokerCheck® program by visiting the FINRA web site ([www.finra.org](http://www.finra.org)) or contacting them at 800-289-9999.

FINRA BrokerCheck® is a free tool to help investors check the professional background of current and former FINRA-registered securities firms and brokers.



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