



CONSOLIDATED STATEMENT OF FINANCIAL  
CONDITION  
UNAUDITED

UBS Financial Services Inc.  
(a Subsidiary of UBS Americas Inc.)  
June 30, 2018

UBS Financial Services Inc.

Consolidated Statement of Financial Condition  
(Unaudited)

June 30, 2018

**Contents**

Consolidated Statement of Financial Condition .....	2
Notes to Consolidated Statement of Financial Condition.....	3

# UBS Financial Services Inc.

## Consolidated Statement of Financial Condition

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### Assets

Cash and cash equivalents	\$ 1,582,733
Cash and securities segregated and on deposit for federal and other regulations	2,058,437
Collateralized agreements:	
Securities purchased under agreements to resell	505,036
Securities borrowed	825,255
Receivables:	
Clients	280,873
Brokers, dealers and clearing organizations	1,425,235
Dividends and interest	10,437
Fees and other	298,668
Financial instruments owned, at fair value	606,749
Financial instruments owned, pledged as collateral, at fair value	124,715
Financial assets designated at fair value	4,121,723
Receivables from affiliated companies	46,390
Office equipment and leasehold improvements (net of accumulated depreciation and amortization of \$876,109)	725,068
Goodwill and intangibles	555,410
Deferred tax asset	661,413
Other assets	465,049
Total assets	\$ 14,293,191

### Liabilities and stockholder's equity

Collateralized agreements:	
Securities sold under agreements to repurchase	239,230
Securities loaned	267,414
Payables:	
Clients	1,209,226
Brokers, dealers and clearing organizations	174,194
Dividends and interest	16,557
Financial instruments sold, not yet purchased, at fair value	47,254
Financial liabilities designated at fair value	4,673,439
Accrued compensation and benefits	1,522,708
Payables to affiliated companies	378,858
Income taxes payable	5,040
Other liabilities and accrued expenses	1,420,496
	9,954,416
Subordinated liabilities	1,200,000
Stockholder's equity	3,138,775
Total liabilities and stockholder's equity	\$ 14,293,191

See notes to consolidated statement of financial condition.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **1. Organization**

UBS Financial Services Inc. ("UBSFSI") is registered as a broker-dealer with the Securities and Exchange Commission ("SEC"), a futures commission merchant with the Commodity Futures Trading Commission ("CFTC") and the National Futures Association and is a member of various exchanges and the Financial Industry Regulatory Authority ("FINRA"). UBSFSI's business activities include securities and commodities brokerage, investment advisory and asset management services to serve the investment, cash management, financial planning and borrowing needs of individual and institutional clients.

UBSFSI is a wholly owned subsidiary of UBS Americas Inc. ("UBS Americas") which is a wholly owned subsidiary of UBS Americas Holding LLC ("UBSAHL"). UBSAHL was established in order to become the intermediate holding company for all United States subsidiaries of UBS Group AG ("UBS") pursuant to the rules enacted for foreign banks in the United States. UBSAHL is a wholly owned subsidiary of UBS AG which is a wholly owned subsidiary of UBS.

### **2. Summary of Significant Accounting Policies**

#### **Principles of Consolidation and Basis of Presentation**

The consolidated statement of financial condition includes the accounts of UBSFSI and its wholly owned subsidiaries (collectively, the "Company"), the largest of which is UBS Financial Services Incorporated of Puerto Rico ("UBSFSSIPR"). All material intercompany balances and transactions have been eliminated.

UBSFSI consolidates entities in which UBSFSI has a controlling financial interest. UBSFSI determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity ("VIE"). At June 30, 2018, the Company does not have any interests in VIEs.

The consolidated statement of financial condition is prepared in conformity with accounting principles generally accepted in the United States, which requires management to make judgments and assumptions that affect the amounts reported in the consolidated statement of financial condition and accompanying notes. Actual results could differ from those estimates. Management makes estimates regarding valuations of certain assets and liabilities, the outcome of litigation, the carrying amount of goodwill and other intangible assets, certain accruals and

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

other matters that affect the reported amounts and disclosures of contingencies in the Company's consolidated statement of financial condition .

#### **Cash and Cash Equivalents**

Cash and cash equivalents are defined as highly liquid investments, with an original maturity of three months or less when purchased. At June 30, 2018, the Company had cash equivalents of \$9,673 in money market deposit accounts at cost, which approximates fair value.

#### **Financial Instruments**

Financial instruments owned, financial instruments owned and pledged as collateral, and financial instruments sold, not yet purchased are stated at fair value and are recorded on a trade date basis. These financial instruments primarily represent the Company's trading assets and investments in equity instruments. Fair value is determined by quoted market prices, when available. If quoted market prices are not available, fair value is determined using pricing models which incorporate management's best estimates of critical assumptions, which take into account time value, volatility and other factors underlying the securities.

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 820, "Fair Value Measurements" ("ASC 820"), defines fair value, establishes a framework for measuring fair value, and establishes a fair value hierarchy which prioritizes the inputs to valuation techniques. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. Valuation techniques, as specified by ASC 820, are used to measure fair value.

The Company's fair value and valuation model governance structure includes numerous controls and procedural safeguards that are intended to maximize the quality of fair value measurements reported in the consolidated statement of financial condition. In carrying out valuation responsibilities, the businesses are required to consider the availability and quality of external market information and to provide justification and rationale for their fair value estimates. Independent price verification of financial instruments measured at fair value is undertaken by

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

UBS's valuation control group. The objective of the independent price verification process is to independently corroborate the business's estimates of fair value against observable market information. By benchmarking the business's fair value estimates with observable market information, the degree of valuation uncertainty embedded in these measurements can be assessed and managed as required in the governance framework. As a result of the valuation controls employed, valuation adjustments may be made to the business's estimate of fair value.

All financial instruments at fair value are categorized into one of three fair value hierarchy levels, based upon the lowest level input that is significant to the financial instrument's fair value measurement in its entirety:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company can access at the measurement date.

Level 2: Valuation techniques for which all significant inputs are, or are based on, observable market data.

Level 3: Valuation techniques which include significant inputs that are not based on observable market data.

The following is a description of the valuation techniques applied to the Company's major categories of assets and liabilities measured at fair value:

*U.S. Government securities and agency obligations:* U.S. Government securities are generally actively traded and are valued using quoted market prices. Where market prices are not available, these securities are valued against yield curves implied from similar issuances. Agency obligations are comprised of agency-issued debt. Non-callable agency-issued debt securities are generally valued using quoted market prices. Callable agency-issued debt securities are valued by benchmarking model-derived prices to quoted market prices and trade data for identical or comparable securities.

*Equities:* Equity securities are primarily traded on public stock exchanges where quoted prices are readily and regularly available. Equity securities not traded on a public stock exchange are valued using observable inputs. Unlisted equity securities and private equity investments are recorded initially at the acquisition cost, which is considered the best indication of fair value. Subsequent adjustments to recorded amounts are based on current and projected financial performance, recent financing activities, economic and market conditions, market comparable, market liquidity, sales restrictions and other factors.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

### 2. Summary of Significant Accounting Policies (continued)

*Mutual funds:* Mutual funds are generally valued using quoted market prices or valuation techniques which use observable inputs if not traded in an active market. In some instances significant inputs are not based on observable market data.

*Corporate debt obligations:* Corporate bonds are priced at fair market value, which are based on recent trades or broker and dealer quotes. In cases where no directly comparable price is available, the bonds are priced against yields derived from other securities by the same issuer or valued using similar securities adjusting for seniority, maturity and liquidity. For illiquid securities, credit modeling may be used, which considers the features of the security and discounted cash flows using observable or implied credit spreads and prevailing interest rates.

*State and municipal obligations:* These securities are comprised of bonds issued by states and municipalities. These financial instruments are priced based on recent trades or broker and dealer quotes.

*Certificates of deposit:* These financial instruments have short and long term maturities and carry interest rates that approximate market. Certificates of deposit are valued at amortized cost plus interest which approximates fair value.

*Mortgage-backed obligations:* Mortgage-backed obligations represent agency mortgage pass-through pool securities and collateralized mortgage obligations ("CMO"). Pass-through pools are valued using quoted market prices or prices on comparable securities after considering collateral characteristics, historical performance and also pricing benchmark securities. Agency CMOs are structured deals backed by specific pool collateral and are valued based on available trades or market comparable securities. Both asset classes require a view around forward interest rates, prepayments and other macro variables.

*Brokerage receivables and payables:* These assets and liabilities represent callable, on demand balances whereby the fair value is determined based on the value of the underlying balances (refer to note 5).

### Collateralized Agreements

Securities purchased under agreements to resell ("resale agreements") and securities sold under agreements to repurchase ("repurchase agreements") are generally collateralized by U.S. government securities, and are accounted for as financing transactions at their contractual amounts, plus accrued interest which represents amounts at which the securities will be subsequently resold or repurchased.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

For resale agreements, it is Company policy to obtain collateral in the form of securities, which has a fair value in excess of the original principal amount loaned. The Company is required to deliver securities to counterparties in order to collateralize repurchase agreements. The risk related to a decline in the market value of collateral (pledged or received) is managed by setting appropriate market-based haircuts. On a daily basis, the Company monitors the fair value of the securities purchased and sold under these agreements. Should the fair value of the securities purchased decline, or the fair value of securities sold increase, additional collateral is requested or excess collateral is returned when deemed appropriate to maintain contractual margin protection.

The Company manages credit exposure arising from resale and repurchase agreements by, in appropriate circumstances, entering into master netting agreements and collateral agreements with counterparties that provide the Company, in the event of a counterparty default (such as bankruptcy or a counterparty's failure to pay or perform), with the right to net a counterparty's rights and obligations under such agreement and liquidate and set off collateral held by the Company against the net amount owed by the counterparty. The Company elects to net repurchase agreements and resale agreements when the requirements of FASB ASC 210-20-45-11 "Balance Sheet – Offsetting: Repurchase and Reverse Repurchase Agreements" are met. As of June 30, 2018, the Company did not net any resale and repurchase agreements.

Securities borrowed and securities loaned transactions are recorded at the amount of cash advanced or received in connection with the transaction. Securities borrowed transactions require the Company to deposit cash or other collateral with the lender. With respect to securities loaned, the Company receives collateral, principally cash. The initial collateral advanced or received has a fair value equal to or greater than the fair value of the securities borrowed or loaned. The Company monitors the fair value of the securities borrowed and loaned on a daily basis and requests additional collateral or returns excess collateral, as appropriate. Accrued interest income and expense on these transactions is reflected in dividends and interest receivable and payable on the consolidated statement of financial condition.

### **Principal Transactions**

When acting as a principal, the Company enters into a transaction in its own name and for its own account. As a principal, the Company has beneficial ownership of and legal title to the assets. Transactions in which securities flow through the Company's inventory are considered principal transactions. The Company assumes both credit risk and market risk from the inception of the transaction. Amounts receivable and payable for principal transactions that have



# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

not reached their contractual settlement date are recorded as receivables from and payables to brokers, dealers and clearing organizations in the consolidated statement of financial condition.

#### **Depreciation and Amortization**

The Company depreciates office equipment using the straight-line method over estimated useful lives of three to ten years. Leasehold improvements are amortized over the lesser of the estimated useful life of the asset or the remaining term of the lease.

#### **Income Taxes**

The Company is included in the consolidated federal income tax return and certain combined state and local tax returns of UBS Americas. In addition, the Company files stand-alone returns in other state, local and foreign jurisdictions. Federal, state, local and foreign taxes are provided for on a separate return basis.

In accordance with the provisions of FASB ASC Topic 740 – “Income Taxes” (“ASC Topic 740”), deferred tax assets and liabilities are recognized for the future tax effect of differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to be in effect during the year in which the basis differences reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in earnings in the period that includes the enactment date. In the event it is more likely than not that a deferred tax asset will not be realized, a valuation allowance is recorded.

ASC Topic 740 also sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions. This interpretation uses a two-step approach wherein a tax benefit is recognized if a position is more likely than not to be sustained. The amount of the benefit is then measured to be the highest tax benefit that is greater than 50% likely to be realized.

#### **Goodwill and Intangible Assets**

Goodwill represents the excess of the cost of an acquisition over the fair value of the Company’s share of net identifiable assets of the acquired entity at the date of acquisition. Goodwill is not amortized but is tested, at least annually, for impairment in accordance with FASB ASC 350 “Intangibles – Goodwill and Other”. The Company has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If after the qualitative assessment the Company determines it is more likely than not that the fair value of a reporting unit is greater than its carrying amount, then performing the two-step impairment

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

test is not required. However, if the Company concludes otherwise, then it is required to perform the first step of the two-step impairment test. The Company has an unconditional option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two step goodwill impairment test. The Company may resume performing the qualitative assessment in any subsequent period. The first step, used to identify potential impairment, involves comparing each reporting unit's fair value to its carrying value including goodwill and intangible assets. If the fair value of a reporting unit exceeds its carrying value, applicable goodwill and intangible assets is considered not to be impaired. If the carrying value exceeds fair value, there is an indication of impairment and the second step is performed to measure the amount of impairment.

At June 30, 2018, the Company had goodwill of \$553,157 resulting primarily from the acquisitions of Piper Jaffrey Companies and McDonald Investments in September 2006 and February 2007, respectively. Intangible assets are recorded at cost, which represents the fair value of the acquired intangible assets at the date of acquisition and are amortized over three to seven years. The Company's intangible assets mainly consist of mortgage service rights. At June 30, 2018 the Company held \$2,253 of intangible assets, net of accumulated amortization of \$465. The Company tests intangible assets, at least annually, for impairment by assessing whether the carrying value of the finite life intangible asset exceed its fair value, based upon its future expected cash flows.

### **Receivables from Clients and Allowance for Doubtful Accounts**

Receivables from clients consist of Non-purpose loans ("Loans") (see note 7). The Company reports these Loans at the outstanding principal amount adjusted for any charge offs or allowances for doubtful accounts. Any allowance for doubtful accounts represents the Company's estimate of losses inherent in the loan portfolio as of the date of the consolidated statement of financial condition. The Company's exposure to credit risk associated with its Loans is measured on an individual customer basis. All Loans are subject to the Company's credit review and monitoring procedures.

Loans are evaluated for impairment in accordance with FASB ASC 310, "Receivables". A loan is determined to be impaired when it is probable, based on current information and events, that the Company will not be able to collect all the principal and interest due under the contractual terms of the loan. If a Loan is considered impaired, the Company measures the amount of impairment based on the fair value of the collateral. Loans are generally placed on non-accrual status at the point when a maintenance call is not satisfied by the borrower. Any accrued interest receivable related to a Loan that is placed on non-accrual status is added to the principal amount

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

due. Payments received while a Loan is on non-accrual status are recorded as a reduction of principal. If the borrower has demonstrated over a period of time, the ability to make periodic interest and principal payments as scheduled, the loan will be returned to accrual status.

As of June 30, 2018, there was no allowance for doubtful accounts.

### **Share-based and Other Deferred Compensation Plans**

UBS has established several share-based compensation plans that are settled in UBS's equity instruments or an amount that is based on the value of such instruments. These awards are generally subject to conditions that require employees to complete a specified period of service and, for performance shares, to satisfy specified performance conditions. For equity-settled instruments, fair value is determined at the date of grant and is not re-measured unless its terms are modified such that the fair value immediately after modification exceeds the fair value immediately prior to modification. For cash-settled awards, fair value is re-measured at each reporting date.

UBS has established deferred compensation plans that are settled in cash or financial instruments other than UBS equity, the amount of which may be fixed or may vary based on the achievement of specified performance conditions or the value of specified underlying assets.

For share-based and other deferred compensation plans, where the service period is shortened for certain reasons, recognition of expense is accelerated to the termination date. When no future service is required, such as for employees who are retirement-eligible or who have met certain age and length of service criteria, the services are presumed to have been received and compensation expense is recognized immediately on, or prior to, the date of grant.

### **Accounting Developments**

#### **Adopted in 2018**

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers". Subsequently, the FASB has issued further ASUs (collectively, the "ASUs") for purposes of amending or clarifying that guidance. The ASUs establish principles for revenue recognition that apply to all contracts with customers except those relating to financial instruments, leases and insurance contracts and requires an entity to recognize revenue as performance obligations are satisfied. In particular, the standard now specifies that variable consideration is only recognized to the extent that it is highly probable that a significant reversal will not occur when the

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

uncertainty associated with the variable consideration is subsequently resolved. It also provides guidance on when revenues and expenses should be presented on a gross or net basis and establishes a cohesive set of disclosure requirements for information on the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers. The Company adopted the standard as of its mandatory effective date on January 1, 2018, on a modified retrospective basis. The adoption of the standard did not have a material impact on the Company's consolidated statement of financial condition.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities". In February 2018, the FASB issued ASU No. 2018-03, Technical Corrections and Improvements to Financial Instruments, to clarify certain provisions in ASU 2016-01. The ASUs address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendment primarily affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements for financial instruments. The Company adopted both of the ASUs as of their mandatory effective date on January 1, 2018 and in line with transitional provisions the adoption did not have a material impact on the Company's consolidated statement of financial condition.

In August 2016, the FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments" (a consensus of the Emerging Issues Task Force). This ASU addresses how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230, Statement of Cash Flows, and other Topics. The Company adopted the standard as of its mandatory effective date on January 1, 2018. This guidance will not have a material impact on the Company's consolidated statement of cash flows.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes" (Topic 740): Intra-Entity Transfers of Assets Other than Inventory. This amendment requires an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. The Company adopted the standard as of its mandatory effective date on January 1, 2018 and adoption did not have a material impact on its consolidated statement of financial condition.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows" (Topic 230); Restricted Cash ("ASU 2016-18"). The amendment requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalent, and amounts generally described as restricted cash or restricted cash equivalents. As a result, amounts generally

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown in the statement of cash flows. The amendment does not provide a definition of restricted cash or restricted cash equivalents. The Company adopted that standard as of its mandatory effective date on January 1, 2018 and adoption will not have a material impact on the Company's consolidated statement of cash flows.

In January 2017, the FASB issued ASU No. 2017-01, "Business Combinations" (Topic 805): Clarifying the Definition of a Business. The ASU clarifies the definition of a business by introducing a quantitative screen to determine when a set is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. If the screen is not met, in order to be considered a business, a set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The Company adopted the standard as of its mandatory effective date on January 1, 2018. Adoption of the ASU did not have a material impact on the Company's statement of financial condition as the ASU is applied prospectively; however, the impact of the ASU will depend upon the acquisition and disposal activities of the Company.

In March 2017, the FASB issued ASU 2017-07, "Compensation—Retirement Benefits" (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The ASU requires that an employer disaggregate the service cost component from other components of net benefit costs. The service cost component of net periodic pension and postretirement benefit cost should be reported in the same financial statement line item(s) as other current employee compensation costs arising from services rendered by employees. All other components of net benefit cost must be presented separately in the income statement from the service cost component. The Company adopted the standard as of its mandatory effective date on January 1, 2018. This change in presentation did not affect the Company's consolidated statement of financial condition.

In May 2017, the FASB issued ASU No. 2017-09, "Receivables—Compensation—Stock Compensation" (Subtopic 718): Scope of Modification Accounting, which amends the accounting for modifications of share-based payment awards. The amendments require that modification accounting be applied when a change to the terms or conditions of an award is substantive. The Company adopted the standard as of its mandatory effective date on January 1, 2018 and adoption did not have a material impact on the Company's consolidated statement of financial condition.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

#### **Pending Adoption**

In February 2016, the FASB issued ASU 2016-02, "Leases", which will come into effect on January 1, 2019. The standard substantially changes how lessees must account for operating lease commitments, requiring an on-balance sheet liability with a corresponding right-of-use asset to be recognized on the balance sheet, as compared with the current off-balance sheet treatment of such leases. Early adoption is permitted. The Company will adopt ASU 2016-02 on the effective date and expects to report an increase in assets and liabilities from adoption in line with its operating lease commitments as of January 1, 2019.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses" (Topic 326) Measurement of Credit Losses on Financial Instruments. The amendment replaces existing incurred loss impairment guidance and introduces a new credit loss model; the Current Expected Credit Losses model ("CECL"), which requires earlier recognition of credit losses. The CECL model requires the measurement of all expected credit losses for financial assets carried at amortized cost based on historical experience, current conditions and reasonable and supportable forecasts over the full remaining expected life of the financial assets. The amendment is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. The adoption of ASU 2016-13 is part of the Group's key strategic initiative for adoption of an expected credit loss approach in provisioning for impairment. The implementation project structure is defined to address the critical requirements of the standard and to manage the appropriate involvement of key stakeholders, including risk control, finance, group technology and the business divisions. The steering committee, operating committee, technical board and individual work streams continue to ensure a streamlined implementation with appropriate controls and governance over all key decisions. The program has identified the primary changes to existing systems, processes, data and models required for the purposes of meeting the requirements and to allow for a sound front-to-back implementation. The Company will adopt ASU 2016-13 on its mandatory effective date, January 1, 2020.

In January 2017, the FASB issued ASU 2017-04, "Simplifying the Test for Goodwill Impairment". ASU 2017-04 simplifies the subsequent measurement of goodwill by eliminating step 2 from the goodwill impairment test. Under step 2 of the goodwill impairment test, a goodwill impairment loss was measured by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, the goodwill impairment test will require an impairment loss to the extent the carrying amount of a reporting unit exceeds its fair value. ASU 2017-04 is effective for goodwill impairment tests in annual reporting periods beginning after December 15, 2019, and for the interim periods within those annual reporting

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **2. Summary of Significant Accounting Policies (continued)**

periods with early adoption permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. ASU 2017-04 is to be applied on a prospective basis. The Company plans to adopt ASU 2017-04 on its effective date. Based upon current goodwill impairment test results, the Company does not expect the adoption of ASU 2017-04 to have a material impact on the Company's consolidated statement of financial condition.

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, to address a financial report issue that arose as a result of the Tax Cuts and Jobs Act, enacted on December 22, 2017. The accounting for the re-measurement of the Company's deferred tax balances due to the reduction in the U.S. corporate income tax rate from 35 to 21 percent resulted in stranded tax effects within accumulated other comprehensive income for items that were originally recognized in other comprehensive income rather than in net income. ASU 2018-02 allows companies the option to record a one-time reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The guidance is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption in any period is permitted. The Company has determined that it will not early adopt ASU 2018-02 and will continue to evaluate its options.

UBS Financial Services Inc.

Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

**3. Fair Value Measurement**

At June 30, 2018, the fair value hierarchy classification of financial assets and liabilities measured at fair value is summarized below:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>Financial instruments owned, at fair value</b>				
U.S. Government securities and agency obligations	\$ 1,966	\$ 4,382	\$ -	\$ 6,348
Equities	2,250	25,718	14,726	42,694
Mutual funds	195,250	-	8,030	203,280
Corporate debt obligations	-	49,905	-	49,905
State and municipal obligations	-	294,576	-	294,576
Certificates of deposit and money market funds	-	5,363	-	5,363
Mortgage-backed obligations	-	4,583	-	4,583
Total	<u>\$ 199,466</u>	<u>\$ 384,527</u>	<u>\$ 22,756</u>	<u>\$ 606,749</u>

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>Financial instruments owned, pledged as collateral, at fair value</b>				
U.S. Government securities and agency obligations	\$ 124,715	\$ -	\$ -	\$ 124,715

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>Financial assets designated at fair value</b>				
Brokerage receivables	\$ -	\$ 4,121,723	\$ -	\$ 4,121,723

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>Financial instruments sold, not yet purchased at fair value</b>				
U.S. Government securities and agency obligations	\$ 13,764	\$ 99	\$ -	\$ 13,863
Equities	5,093	4,662	-	9,755
Corporate debt obligations	-	22,406	-	22,406
State and municipal obligations	-	817	-	817
Certificate desposit and money market funds	-	412	-	412
Mortgage-backed obligations	-	1	-	1
Total	<u>\$ 18,857</u>	<u>\$ 28,397</u>	<u>\$ -</u>	<u>\$ 47,254</u>

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>Financial liabilities designated at fair value</b>				
Brokerage payables	\$ -	\$ 4,673,439	\$ -	\$ 4,673,439



UBS Financial Services Inc.

Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

**3. Fair Value Measurement (continued)**

Prior to January 1, 2018, brokerage receivables and brokerage payables (see note 5) were recognized at amortized cost. As of this date, the Company elected the fair value option for reporting these assets and liabilities. As they represent on-demand balances, the positions are effectively new each day and the fair value option can be applied to the entire balance with no notion of legacy positions. There was no difference between the amortized cost carrying amount and the fair value as of January 1, 2018, and therefore, no re-measurement gain or loss has been recognized.

Financial instruments sold, not yet purchased, at fair value represents obligations of the Company to deliver the specified securities at contracted prices and, thereby, requires the Company to purchase the securities in the market at prevailing prices. The Company's ultimate obligation to satisfy the sale of securities sold, not yet purchased may exceed the amount reflected in the consolidated statement of financial condition.

Transfers of financial assets and financial liabilities between the fair value levels are recognized as of June 30 and December 31 each year. During the six months ended June 30, 2018, the Company did not transfer any financial assets or financial liabilities between level 1 and 2.

The Company is the primary liquidity provider in the market for a number of closed-end mutual funds (the "Funds") invested in Puerto Rico municipal securities. These Funds use leverage, which is currently provided through repurchase agreements between the Funds and UBSFSIPR. Since 2013, the Puerto Rico market has experienced a downturn and liquidity issues became prevalent with the Funds. The Company also holds equity investments in privately held companies primarily to facilitate its business activities. The fair value of these Funds and equity investments is based on valuation techniques for which significant inputs are not based on observable market data.

The following table provides a reconciliation of the beginning and ending balances for the various classes of assets measured at fair value using unobservable inputs – Level 3.

	<b>Financial Instruments Owned</b>		
	<b>Mutual Funds</b>	<b>Equities</b>	<b>Total</b>
Beginning balance	\$ 7,184	\$ 8,826	\$ 16,010
Purchases	-	\$ 3,500	\$ 3,500
Sales	(17)	-	(17)
Net unrealized gain	863	\$ 2,400	\$ 3,263
Ending balance	\$ 8,030	\$ 14,726	\$ 22,756

UBS Financial Services Inc.

Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

**3. Fair Value Measurement (continued)**

The following table provides information on the valuation techniques, significant unobservable inputs and the range of values for those inputs for financial instruments owned, at fair value, categorized as Level 3 in the fair value hierarchy at June 30, 2018.

The range of values presented in the below table is representative of the lowest level of input that is significant to the financial instruments' fair value. The disclosure below also includes qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs.

	<b>Financial Instruments Owned</b>	<b>Valuation Technique</b>	<b>Significant Unobservable Inputs</b>	<b>Range of Input Values</b>
Mutual funds	\$8,030	Internally developed model	Discount rates	13% - 36%
Equities	\$14,726	Relative value to market comparable	Price	

**Financial assets and liabilities not measured at fair value**

Other financial assets and liabilities are recorded by the Company at their contract values and include cash and cash equivalents, cash and securities segregated and on deposit for federal and other regulations, resale and repurchase agreements, securities borrowed and securities loaned, receivables and payables from (i) clients, (ii) brokers, dealers and clearing organizations, (iii) affiliated companies, (iv) dividend and interest, (v) fees and other receivables and subordinated debt.

All financial assets and liabilities carried at contract amounts that either have short-term maturities (one year or less) or bear market interest rates are carried at amounts that approximate fair value. The carrying value of non-purpose loans included in receivables from clients approximate fair value as these loans re-price daily and there is no stated maturity date.

The following table represents the carrying value, fair value, and fair value hierarchy category of certain financial assets and liabilities that are not recorded at fair value in the Company's consolidated statement of financial condition. The following table excludes all non-financial assets and liabilities.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

### 3. Fair Value Measurement (continued)

	Carrying Value	Fair Value	(Level 1)	(Level 2)	(Level 3)
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 1,582,733	1,582,733	\$ 1,582,733	\$ -	\$ -
Cash and Securities segregated and on deposit for federal and other regulations	2,058,437	2,058,437	335,388	1,723,049	-
Securities purchased under agreements to resell	505,036	505,036	-	505,036	-
Securities borrowed	825,255	825,255	-	825,255	-
Receivables from clients	280,873	280,873	-	280,873	-
Brokers, dealers and clearing organizations	1,425,235	1,425,235	-	1,425,235	-
Dividends and interest	10,437	10,437	-	10,437	-
Fees and other	298,668	298,668	-	298,668	-
Receivables from affiliated companies	46,390	46,390	-	46,390	-
<b>Financial Liabilities:</b>					
Securities sold under agreements to repurchase	\$ 239,230	\$ 239,230	\$ -	\$ 239,230	\$ -
Securities loaned	267,414	267,414	-	267,414	-
Payables from clients	1,209,226	1,209,226	-	1,209,226	-
Brokers, dealers and clearing organizations	174,194	174,194	-	174,194	-
Dividends and interest	16,557	16,557	-	16,557	-
Payables to affiliated companies	378,858	378,858	-	378,858	-
Subordinated debt	1,200,000	1,200,000	-	1,200,000	-

### 4. Collateralized Agreements

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and for the Company's financing transactions.

### Secured Financing Transactions-Maturities and Collateral Pledged

The following tables present gross obligations, prior to any netting as shown below, for repurchase agreements and securities loaned transactions by remaining contractual maturity and class of collateral pledged as of June 30, 2018.

	Remaining Contractual Maturity				
	Overnight and Open	Less than 30 days	30-90 days	Over 90 days	Total
Securities sold under agreement to repurchase	\$ 161,000	\$ 73,205	\$ 5,025	-	\$ 239,230
Securities loaned	\$ 267,414				\$ 267,414
Total	\$ 428,414	\$ 73,205	\$ 5,025	\$ -	\$ 506,644

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### 4. Collateralized Agreements (continued)

#### Secured Financing by the Class of Collateral Pledged

##### Securities sold under agreement to repurchase

U.S. Government securities and agency obligations

\$ 239,230

Total

\$ 239,230

##### Securities loaned

Equities

\$ 267,414

Total

\$ 267,414

The Company does not have any transactions accounted for as a sale that results in the Company retaining substantially all of the exposure to the economic returns of the transferred asset.

#### Offsetting of Collateral Agreements

The Company manages credit risk by entering into netting agreements with counterparties. These netting agreements generally enable the counterparties to offset liabilities against assets received in the event that the counterparty to the transaction is unable to fulfill its contractual obligation. The Company offsets these financial assets and financial liabilities on the consolidated statement of financial condition only when it has an enforceable legal right to offset the respective recognized amounts and intends to settle on a net basis.

UBS Financial Services Inc.

Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

**4. Collateralized Agreements (continued)**

The following table presents information regarding the offsetting of financial assets and liabilities.

	Gross Amounts	Amounts Offset in the Statement of Financial Condition	Net Amounts Presented in the Statement of Financial Condition	Gross Amounts not offset in the Statement of Financial Condition <sup>(2)</sup>	Net Amount <sup>(3)</sup>
<b>Financial assets</b>					
Securities borrowed	\$ 825,255	\$ -	\$ 825,255	\$ (821,215)	\$ 4,040
Securities purchased under agreements to resell <sup>(1)</sup>	505,036	-	505,036	(505,036)	-
<b>Financial liabilities</b>					
Securities loaned	267,414	-	267,414	(266,774)	\$ 640
Securities sold under agreements to repurchase	239,230	-	239,230	(239,230)	-

- (1) Balance excludes \$1,720,000 in securities purchased under agreements to resell that are segregated pursuant to the Customer Protection Rule and are included in cash and securities segregated and on deposit for federal and other regulations on the consolidated statement of financial condition.
- (2) Amounts relate to master netting agreements and collateral agreements which have been determined by the Company to be legally enforceable in the event of default and where certain other criteria are not met in accordance with applicable offsetting account guidance ASC 210-20-45-11.
- (3) In some cases, collateral exchanged with a counterparty exceeds the net asset or liability balance with that counterparty. In such cases, the amounts reported in this column are limited to the related asset or liability with the counterparty.

In the normal course of business, the Company receives margin securities and obtains securities under agreements to resell and securities borrowed on terms which permit it to re-pledge or resell the securities to others. At June 30, 2018, the Company obtained and had available securities with a fair value of approximately \$6,809,558 on such terms, of which approximately \$3,223,038 have been either pledged or otherwise transferred to others in connection with the Company's financing activities, to satisfy commitments under short sales, or for deposits made to clearing organizations.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### 5. Financial Assets and Financial Liabilities Designated at Fair Value

Financial assets and financial liabilities designated at fair value consist of brokerage receivables and payables. These assets and liabilities represent callable, on-demand balances including margin loans ("Margin Loans"), client cash debits, free cash credits and secured credits (short sale proceeds). The balances reported represent an aggregation of cash receivables and payables that form a single unit of account at the client level. The business model for these accounts is similar to any current or on-demand accounts, with clients using the account to house subscriptions, redemptions and billed amounts. Prior to January 1, 2018, these balances were included in receivables and payables to clients and measured at amortized cost. Clients' securities and commodities transactions are recorded on a settlement date basis. For Margin Loan transactions, the Company will make a loan to a client for purposes of financing the purchase of securities ("Margin Loans"). These transactions are conducted through margin accounts.

The client is required to post collateral in excess of the value of the margin loan and the collateral must meet certain lending value criteria as defined by the Company. Collateral is monitored daily for price volatility in order to maintain adequate margins. If the collateral value drops below the minimum required levels, a maintenance call is issued. The borrower must satisfy the call by providing additional securities or by paying down the loan. If the borrower does not satisfy the call, the Company may liquidate collateral to achieve required levels of collateralizations. Significant market volatility could have a negative impact on the borrower's ability to satisfy the call or the Company's ability to liquidate collateral. To limit the Company's credit risk exposure, the credit facilities are uncommitted.

As of June 30, 2018, financial assets designated at fair value consisted of:

Margin loans	\$	4,088,303
Client cash debits		33,420
Gross receivables	\$	<u>4,121,723</u>

As of June 30, 2018, financial liabilities designated at fair value consisted of:

Free cash credits	\$	3,651,279
Secured credits		1,022,160
Total	\$	<u>4,673,439</u>

Securities owned by clients, including those that collateralize margin or similar transactions, are not reflected on the consolidated statement of financial condition.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### 6. Cash and Securities Segregated and on Deposit for Federal and Other Regulations

The Company is required to segregate cash in a special reserve bank account for the exclusive benefit of customers under SEC Rule 15c3-3 (the "Customer Protection Rule"). The Company also performs a separate computation for assets in the proprietary accounts of broker-dealers ("PAB") in accordance with the Customer Protection Rule. At June 30, 2018 the Company included \$335,388 in cash and \$1,723,049 of qualified securities in cash and securities segregated and on deposit for federal and other regulations.

Included in receivable from brokers, dealers and clearing organizations on the consolidated statement of financial condition is \$32,588 in net liquidating equity segregated pursuant to Section 4d(a)(2) of the Commodity Exchange Act and Regulation 30.7 of the CFTC.

### 7. Receivables From and Payables to Clients

The Company provides securities based lending that allows clients to borrow against the value of qualifying securities for any suitable purpose other than purchasing, trading, or carrying securities ("Non-purpose Loans"). As of June 30, 2018, the Company recognized Non-purpose Loans in the amount of \$280,873. Non-purpose Loans are subject to the same collateral requirements as Margin Loans (refer to Note 5). Payables to clients in the amount of \$1,209,226 consist primarily of deposits in foreign currency.

### 8. Receivables From and Payables to Brokers, Dealers and Clearing Organizations

Amounts receivable from and payable to brokers, dealers and clearing organizations at June 30, 2018, consist of the following:

Receivables from brokers, dealers and clearing organizations:

Securities failed to deliver	\$	82,553
Receivables related to cash clearing activity		1,145,323
Receivables related to commodities clearing activity		37,955
Deposits with clearing organizations		123,825
Pending trades and other		35,579
Total	\$	<u>1,425,235</u>

UBS Financial Services Inc.

Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

**8. Receivables From and Payables to Brokers, Dealers and Clearing Organizations  
(continued)**

Payables to brokers, dealers and clearing organizations:	
Securities failed to receive	\$ 172,014
Other	2,180
Total	\$ 174,194

**9. Related-Party Transactions**

In the normal course of business, the Company enters into transactions with affiliated companies. At June 30, 2018, the consolidated statement of financial condition included the following balances with affiliates:

**Assets**

Cash and cash equivalents	\$ 66,723
Cash and securities segregated and on deposit for federal and other regulations	1,728,057
Securities purchased under agreements to resell	161,000
Securities borrowed	825,255
Financial instruments owned, at fair value	111
Receivables from brokers, dealers and clearing organizations	5,278
Receivables from affiliated companies	46,390

**Liabilities**

Securities sold under agreements to repurchase	\$ 78,230
Securities loaned	267,414
Payables to brokers, dealers and clearing organizations	45,109
Accrued compensation and benefits	66,010
Payables to affiliated companies	378,858
Other liabilities and accrued expense	15,551
Dividend and interest payable	10,799

Subordinated liabilities (Note 10)	\$ 1,200,000
------------------------------------	--------------

Cash and securities segregated and on deposit for federal and other regulations includes a resale agreement with an affiliated counterparty in the amount of \$1,720,000 which the Company has deposited with a third party.



## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **9. Related-Party Transactions (continued)**

##### **Service Level Agreements**

Pursuant to service level arrangements, the Company receives services from / provides services to affiliates (operational / administrative / securities research / premises). The significant arrangements where the Company receives or provides such support services include arrangements with UBS Bank USA ("BUSA"), UBS Business Solutions LLC, UBS Business Solutions AG, UBS Securities LLC ("UBSS LLC"), and UBS AG Stamford branch.

In the normal course of business, the Company enters into resale and repurchase agreements and securities lending transactions with UBSS LLC in order to facilitate client transactions and to meet its short-term financing needs. UBSS LLC also serves as a counterparty to all resale and repurchase agreements whereby the Company has entered into equal and offsetting agreements with independent third parties. Additionally, the Company enters into stock borrow and stock loan transactions with UBSS LLC.

Certain employees of the Company have been issued loans by an affiliate as part of the Company's compensation programs related to employee recruiting and retention (see Note 15).

Retail clients of UBSFSIPR are introduced to UBSFSI on a fully disclosed basis. The Company has a fully disclosed clearing agreement with UBSFSIPR pursuant to which UBSFSI provides certain clearing and related functions. Under this arrangement, UBSFSI assumes the physical custody of, and conducts the brokerage settlement activities for accounts of UBSFSIPR and its clients.

UBSFSI guarantees payment and performance of all liabilities, obligations and commitments of UBSFSIPR. UBSFSI does not receive any consideration for this guarantee.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### 10. Subordinated Liabilities

At June 30, 2018, subordinated borrowings and total credit facilities with UBS Americas consisted of the following:

	<b>Maturity</b>	<b>Amount Outstanding</b>	<b>Total Credit Facility</b>
Revolving subordinated loan	3/31/2020	\$ 450,000	\$ 1,500,000
Revolving subordinated loan	3/31/2023	-	450,000
Subordinated term loan	7/31/2020	400,000	400,000
Subordinated term loan	7/31/2020	200,000	200,000
Subordinated term loan	12/31/2019	150,000	150,000
		\$ 1,200,000	\$ 2,700,000

Revolving subordinated loans bear interest at a rate based upon USD overnight LIBOR as posted daily by the ICE Benchmark Administration ("IBA"). Subordinated term loans are at fixed rates ranging from 1.1% to 2.8%.

These loans are subordinated to claims of general creditors, are covered by agreements approved by FINRA and other regulatory authorities, and are included by the Company for purposes of computing net capital under the SEC Uniform Net Capital Rule. To the extent that such borrowings are required for the Company's continued compliance with minimum net capital requirements, these loans may not be repaid unless first approved by FINRA.

#### 11. Risk Management

The Company's risk management policies and related procedures are aligned with those of UBS. The Company's risk governance framework operates along three lines of defense. The first line of defense, business management, owns respective risk exposures and is required to maintain effective processes and systems to manage its risks, including robust and comprehensive internal controls and documented procedures. Business management has appropriate supervisory controls and review processes in place designed to identify control weaknesses and inadequate processes. The second line of defense, the control functions, provides independent oversight of risks, including assisting in setting risk limits and protecting against non-compliance with applicable laws and regulations. Internal audit forms the third line of defense, evaluation of the overall effectiveness of governance, risk management and the control environment, including the assessment of how the first and second lines of defense meet their objectives.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **11. Risk Management (continued)**

The Company's risk management and control principles are as follows:

- Protection of financial strength. Protecting the financial strength of the Company by controlling risk exposures and avoiding potential risk concentrations at individual exposure levels, at specific portfolio levels and at an aggregate Company level across all risk types.
- Protection of reputation. Protecting the Company's reputation through a sound risk culture characterized by a holistic and integrated view of risk, performance and reward, and through full compliance with the Company's standards and principles, particularly the Company's Code of Business Conduct and Ethics.
- Business management accountability. Ensuring management accountability, whereby business management, as opposed to Risk Control, owns all risks assumed throughout the Company and is responsible for the continuous and active management of all risk exposures to ensure that risk and return are balanced.
- Independent controls. Independent control functions which monitor the effectiveness of the business's risk management and oversee risk-taking activities.
- Risk disclosure. Disclosure of risks to senior management, the Board of Directors, investors, regulators, credit rating agencies and other stakeholders with an appropriate level of comprehensiveness and transparency.

#### **Market Risk**

Market risk is the risk of loss from changes in market variables. There are two broad categories of changes: general market risk factors driven by macroeconomic, geopolitical and other market-wide considerations and market risk factors that are specific to individual companies or entities.

General market risk factors include interest rates, level of equity market indices, foreign currency exchange rates and other factors. Market risk factors that are specific to individual companies or entities cannot be explained by general market moves. In the normal course of business the Company is exposed to general and specific market risks related to its trading activities and some non-trading businesses are also subject to market risk.

The Company has two major portfolio measures to monitor market risk: Value at Risk and Stress Loss. The two major portfolio measures are complemented by concentration and other supplementary limits on portfolios, sub-portfolios or asset classes. The senior management of each relevant business area is responsible for reviewing trading and non-trading positions, exposures, profits and losses, and trading strategies. The Company has a risk control group which reviews the Company's risk profile and independently monitors development in trading and non-trading portfolios according to established limits. The risk control group also reviews

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **11. Risk Management (continued)**

trading positions and economic hedging strategies, performs market risk modeling and aids in setting risk policies of the Company.

#### **Operational Risk**

Operational risk is the risk resulting from inadequate or failed internal processes, people and systems, or from external causes (e.g., deliberate, accidental or natural).

Events may be direct financial losses or indirect in the form of revenue forgone as a result of business suspension. They may also result in damage to the Company's reputation and franchise, which have longer term financial consequences.

Operational risk is an inevitable consequence of being in business, and managing operational risk is a core element of the Company's business activities. It is not possible to eliminate every source of operational risk, but the Company's aim is to provide a framework that supports the identification and assessment of all material operational risks and their potential concentrations in order to achieve an appropriate balance between risk and return.

A comprehensive operational risk taxonomy is established that defines the universe of inherent material operational risks which arise as a consequence of business activities. This enables a common understanding and provides a standard and consistent categorization of operational risk across all business divisions. The aggregated impact of control deficiencies and the adequacy of remediation efforts are assessed by Operational Risk Control for all relevant operational risk taxonomy categories as part of the operational risk assessment process. This front-to-back process, complemented by internal subject matter expertise, provides a transparent assessment of the current operational risk exposure against agreed risk appetite statements and measures.

Significant control deficiencies that surface during the internal control and operational risk assessment processes must be reported in the operational risk inventory and sustainable remediation must be initiated.

#### **Credit Risk**

Credit risk is the risk of financial loss resulting from failure by a client or counterparty to meet its contractual obligations to the Company. This can be caused by factors directly related to the counterparty or from failures in the settlement process. It can also be triggered by economic or

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **11. Risk Management (continued)**

political factors in the country in which the counterparty is based or where it has substantial assets. Counterparties to the Company's financing activities are primarily affiliates, other financial institutions, including banks, brokers and dealers, investment funds and insurance companies, individuals and non-financial operating entities. Credit losses could arise should counterparties fail to perform and the value of any collateral held prove inadequate due to market conditions.

The Company manages credit risk by monitoring net exposure to individual counterparties on a daily basis, monitoring credit limits and requiring additional collateral where appropriate.

Client transactions are entered on either a cash or margin basis. In a margin transaction, the Company extends credit to a client, using the securities purchased and/or other securities held on behalf of the client, as collateral for amounts loaned. Amounts loaned are limited by margin regulations of the Federal Reserve Board and other regulatory authorities and are subject to the Company's credit review and daily monitoring procedures. Market declines could, however, reduce the value of any collateral below the principal amount loaned, plus accrued interest, before the collateral can be sold.

Client transactions include positions in written options, financial instruments sold, not yet purchased and commodities and financial futures. The risk to the Company's clients in these transactions can be substantial, principally due to price volatility which can reduce the clients' ability to meet their obligations. To the extent clients are unable to meet their commitments to the Company and margin deposits are insufficient to cover outstanding liabilities, the Company may take action as appropriate.

Client trades are recorded on a settlement date basis. Should either the client or broker fail to perform, the Company may be required to complete the transaction at prevailing market prices. Trades pending at June 30, 2018 were settled without material adverse effect on the consolidated statement of financial condition, taken as a whole.

Receivables and payables with brokers and dealers, agreements to resell and repurchase securities, and securities borrowed and loaned are generally collateralized by cash, U.S. Government and agency securities. Additional collateral is requested when considered necessary. The Company may pledge clients' margin securities as collateral in support of securities loaned and bank loans, as well as to satisfy margin requirements at clearing organizations. For margin loans, the amounts loaned or pledged are limited to the extent permitted by applicable margin regulations. Should the counterparty fail to return the clients' securities, the Company may be

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **11. Risk Management (continued)**

required to replace them at prevailing market prices. At June 30, 2018, the market value of securities loaned to other brokers approximated the amounts due or collateral obtained.

The Company has direct exposure to Puerto Rico municipal securities and closed-end funds arising from its secondary market activities, which was \$8,110 at June 30, 2018. In addition, securities-backed lending facilities, including purpose and non-purpose loans, provided by the Company to its customers and repurchase agreements with institutional clients are, in part, collateralized by Puerto Rico municipal securities and closed-end funds primarily invested in Puerto Rico municipal securities. This collateral is subject to lending value haircuts and daily margining.

Since 2015, the Commonwealth of Puerto Rico along with certain agencies and public corporations of the Commonwealth have defaulted on various debt instruments. In May 2017, certain debt of the Commonwealth was placed into a bankruptcy-like proceeding (refer to Note 12). As a result of these recurring events, the Company continues to limit lending value on most Puerto Rico municipal securities and closed-end funds.

The total lending exposure against Puerto Rico municipal securities and closed-end fund collateral at June 30, 2018 was \$7,624. The underlying collateral had a market value of \$33,304 as of this date. For a significant number of these loans, the Company has recourse to the borrower.

### **12. Commitments and Contingencies**

#### **Leases**

The Company leases office space and equipment under non-cancelable operating and capital lease agreements, which expire at various dates through 2031. The aggregate minimum future payments required by operating leases with initial or remaining lease terms exceeding one year, were as follows:

UBS Financial Services Inc.

Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

**12. Commitments and Contingencies (continued)**

	<b>Total Rent Payments</b>	<b>Total Sublease Receipts</b>
2018 (July - December)	\$ 86,545	\$ 12,698
2019	183,584	29,837
2020	178,588	30,470
2021	165,191	30,778
2022	151,930	30,780
2023 and thereafter	522,356	30,269
	<u>\$ 1,288,194</u>	<u>\$ 164,832</u>

Rentals are subject to periodic escalation charges and do not include amounts payable for insurance, taxes and maintenance. In addition, minimum payments have not been reduced by future sublease rental income.

As of June 30, 2018, the Company had recorded an onerous lease provision in the amount of \$125,417 related to the Company vacating certain premises prior to the expiration of the lease terms. During the six months ended June 30, 2018, increased subtenant occupancy related to these premises resulted in a reduction of the provision by \$20,000. The liability is included in other liabilities and accrued expenses in the consolidated statement of financial condition.

**Legal Proceedings**

The Company operates in a legal and regulatory environment that exposes it to significant litigation risks and similar risks arising from disputes and regulatory proceedings. As a result, the Company is involved in various disputes and legal proceedings, including litigation, arbitration, and regulatory and criminal investigations.

Such matters are subject to many uncertainties, and the outcome and timing of resolution are often difficult to predict, particularly in the earlier stages of a case. There are also situations where the Company may enter into a settlement agreement. This may occur in order to avoid the expense, management distraction or reputational implications of continuing to contest liability, even for those matters for which the Company believes it should be exonerated. The uncertainties inherent in all such matters affect the amount and timing of any potential outflows

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **12. Commitments and Contingencies (continued)**

for both matters with respect to which provisions have been established and other contingent liabilities. The Company makes provisions for matters brought against it when, in the opinion of management after seeking legal advice, it is more likely than not that the Company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required, and the amount can be reliably estimated. Where these factors are otherwise satisfied, a provision may be established for claims that have not yet been asserted against the Company, but are nevertheless expected to be, based on the Company's experience with similar asserted claims. Such provisions would be included in the other liabilities and accrued expenses on the consolidated statement of financial condition. If any of those conditions are not met, such matters result in contingent liabilities. If the amount of an obligation cannot be reliably estimated, a liability exists that is not recognized even if an outflow of resources is probable. Accordingly, no provision is established even if the potential outflow of resources with respect to such matters could be significant.

It is not practicable to provide an aggregate estimate of liability for our litigation, regulatory and similar matters as a class of contingent liabilities. Doing so would require the Company to provide speculative legal assessments as to claims and proceedings that involve unique fact patterns or novel legal theories, which have not yet been initiated or are at early stages of adjudication, or as to which alleged damages have not been quantified by the claimants. Although we therefore cannot provide a numerical estimate of the future losses that could arise from the class of litigation, regulatory and similar matters, the Company believes that the aggregate amount of possible future losses from this class that are more than remote substantially exceeds the level of current provisions.

In the matters disclosed below, the Company does not state whether a provision has been established. Either a) the Company has not established a provision and the matter is treated as a contingent liability under the applicable accounting standard or b) the Company has established a provision but expects disclosure of that fact would prejudice seriously the Company's position with other parties in that matter because it would reveal the fact that the Company believes an outflow of resources to be probable and reliably estimable. In addition to the matters mentioned below, the Company is involved in litigation as well as regulatory matters arising in the normal course of business.

#### **Puerto Rico Matters**

Declines since 2013 in the market prices of Puerto Rico municipal bonds and the Funds that are sole-managed and co-managed by UBS Trust Co. of Puerto Rico ("UBS Trust of PR") and



## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **12. Commitments and Contingencies (continued)**

distributed by UBSFSIPR have led to multiple regulatory inquiries, as well as customer complaints and arbitrations with aggregate claimed damages of approximately \$2,600,000 of which claims with aggregate claimed damages of \$1,600,000 have been resolved through settlements, arbitrations or withdrawal of the claim. The claims are filed by clients in Puerto Rico who own the Funds or Puerto Rico municipal bonds and/or who used their UBS account assets as collateral for UBS non-purpose loans; customer complaint and arbitration allegations include fraud, misrepresentation and unsuitability of the Funds and of the loans.

A shareholder derivative action was filed in 2014 against UBSFSI, UBSFSIPR and UBS Trust of PR and current and certain former directors of the Funds, alleging hundreds of millions in losses in the Funds. In 2015, defendants' motion to dismiss was denied. Defendants' requests for permission to appeal that ruling were denied by the Puerto Rico Court of Appeals and the Puerto Rico Supreme Court. In 2014, a federal class action complaint was also filed against various UBS entities included the UBSFSI, UBSFSIPR and UBS Trust of PR, certain members of UBSFSIPR's senior management, and the co-manager of certain of the Funds seeking damages for investor losses in the Funds during the period from May 2008 through May 2014. In 2016, defendants' motion to dismiss was granted in part and denied in part.

In 2015 a class action was filed in Puerto Rico state court against UBSFSIPR seeking equitable relief in the form of a stay of any effort by UBSFSIPR to collect on non-purpose loans it acquired from UBS BUSA in December 2013 based on plaintiffs' allegation that the loans are not valid. The trial court denied defendants' motion for summary judgment based on a forum selection clause in the loan agreements. The Puerto Rico Supreme Court reversed that decision and remanded the case back to the trial court for reconsideration. On reconsideration the trial court granted defendant's motion and dismissed the action.

In 2014 UBSFSIPR reached a settlement with the Office of the Commissioner of Financial Institutions for the Commonwealth of Puerto Rico ("OCFI") in connection with OCFI's examination of UBSFSIPR's operations from January 2006 through September 2013, pursuant to which the Company is paying up to an aggregate of \$7,700 in investor education contributions and restitution.

In 2015, the SEC and FINRA announced settlements with UBSFSIPR of their separate investigations stemming from the 2013 market events. Without admitting or denying the findings in either matter, UBSFSIPR agreed in the SEC settlement to pay \$15,000 and \$18,500 in the FINRA matter. The Company also understands that the Department of Justice is conducting a

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **12. Commitments and Contingencies (continued)**

criminal inquiry into the impermissible reinvestment of non-purpose loan proceeds. The Company is cooperating with the authorities in this inquiry.

In 2011, a purported derivative action was filed on behalf of the Employee Retirement System of the Commonwealth of Puerto Rico (the "System") against over forty defendants, including UBSFSIPR, which was named in connection with its underwriting and consulting services. The plaintiffs alleged that defendants violated their purported fiduciary duties and contractual obligations in connection with the issuance and underwriting of approximately \$3,000,000 of bonds by the System in 2008 and sought damages of over \$800,000. In 2016, the court granted the System's request to join the action as a plaintiff, but ordered that plaintiffs must file an amended complaint. In 2017, the court denied defendants' motion to dismiss the amended complaint.

Beginning in 2015, and continuing through 2017, certain agencies and public corporations of the Commonwealth of Puerto Rico defaulted on certain interest payments on Puerto Rico bonds. The Funds hold significant amounts of those bonds and the defaults on interest payments have had, and are expected to continue to have, an adverse effect on dividends from the Funds. Executive orders of the Governor of Puerto Rico that have diverted funds to pay for essential services instead of debt payments and stayed any action to enforce creditors' rights on the Puerto Rico bonds continue to be in effect. In 2016, United States federal legislation created an oversight board with power to oversee Puerto Rico's finances and to restructure its debt. The oversight board has imposed, a stay on exercise of creditors' rights. In 2017, the oversight board placed certain on the bonds into a bankruptcy-like proceeding under the supervision of a Federal District Judge. These events, further defaults, any further legislative action to create a legal means of restructuring Commonwealth obligations or to impose additional oversight on the Commonwealth's finances, or any restructuring of the Commonwealth's obligations, may increase the number of claims against UBSFSIPR concerning Puerto Rico securities as well as potential damages sought.

The Company's consolidated statement of financial condition as of June 30, 2018, reflects provisions with respect to these matters in amounts that the Company believes to be appropriate under the applicable accounting standards. As in the case of other matters for which the Company has established provisions, the future outflow of resources in respect of such matters cannot be determined with certainty based on currently available information, and accordingly may ultimately prove to be substantially greater (or may be less) than the provisions that have been recognized.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **12. Commitments and Contingencies (continued)**

##### **Guarantees**

The Company has guaranteed the payment and performance obligations of UBS Swiss Financial Advisers AG ("SFA"), an investment adviser registered with the SEC, as it relates to certain transactions that SFA conducts in connection with the Company's clients. The guarantee is subject to a limit of \$100,000.

The Company is a member of various exchanges and clearinghouses that trade and clear securities and/or derivative contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse. While the rules governing different exchange or clearinghouse members vary, in general, the Company's guarantee obligations would arise only if the exchange or clearinghouse had previously exhausted its resources. In addition, any such guarantee obligation would be apportioned among the other non-defaulting members of the exchange. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in its consolidated statement of financial condition for the agreements and believes that any potential requirement to make payments under these agreements is remote.

##### **Other Commitments and Contingencies**

At June 30, 2018 the Company is contingently liable under standby letters of credit issued by third party banks, totaling \$73,579.

In meeting the financing needs of certain of its clients, the Company may also issue standby letters of credit, which are fully collateralized by customer margin securities. At June 30, 2018, the Company had outstanding \$188,707 of such standby letters of credit.

In the normal course of business, the Company enters into when-issued transactions and underwriting commitments. Settlement of these transactions after June 30, 2018 did not have a material impact on the consolidated statement of financial condition, taken as a whole. There are no material underwriting commitments at June 30, 2018.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### 13. Consolidated Subsidiaries

The following is a summary of certain financial information of the Company's consolidated subsidiaries at June 30, 2018:

	<b>UBSFSI per FOCUS (unaudited)</b>	<b>Other Subsidiaries</b>	<b>Eliminations/ Other</b>	<b>UBSFSI Consolidated</b>
Total assets	\$ 13,789,607	\$ 642,507	\$ (138,923)	\$ 14,293,191
Total stockholder's equity	\$ 3,133,683	\$ 118,567	\$ (113,475)	\$ 3,138,775

The Company prepares Part II of Form X-17A-5 using the flow-through method allowed pursuant to Appendix C of 17 CFR 240.15c3-1 ("the Net Capital Rule"). Accordingly, at June 30, 2018, the computation of net capital in accordance with the Net Capital Rule includes \$146,069 of flow through capital of UBSFSIPR. See Note 14 Net Capital Requirements.

#### 14. Net Capital Requirements

The Company is subject to the Net Capital Rule. The Company computes its net capital requirement under the alternative method. Under this method of computing capital requirements, minimum net capital shall not be less than 2% of combined aggregate debit items arising from the Company's SEA Rule 15c3-3 customer reserve computation as defined in SEA 15c3-1(a)(1)(22)/01, plus excess margin collected on resale agreements. A reduction of business is required if net capital is less than 4% of such aggregate debit items. Business may not be expanded if net capital is less than 5% of such aggregate debit items. The Company is also subject to the CFTC's minimum financial requirement set forth in Regulation 1.17 of the Commodity Exchange Act. The Company's net capital of \$1,217,259 was 20.53% of its June 30, 2018 aggregate debit items and its net capital in excess of the minimum required was \$1,098,580.

The Company is subject to certain notifications and other provisions of the Net Capital Rule to disclose any advances and repayments of subordinated liabilities, as well as dividend and other equity withdrawals.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **15. Equity Participation and Other Compensation Plans**

UBS has several equity participation and other compensation plans to align the interests of executives, managers and staff with the interests of shareholders while continuously meeting regulatory requirements.

##### **Equity Ownership Plan (“EOP”)**

EOP is a mandatory share-based compensation plan for all employees with total compensation above a defined threshold. These employees receive a portion of their annual performance-related compensation above the threshold in the form of notional shares. Furthermore, notional shares granted to (i) Group Managing Directors, (ii) employees who by the nature of their role have been determined to materially set, commit or control significant amounts of the firm's resources or exert significant influence over its risk profile and (iii) employees whose incentive exceeds a certain threshold are subject to performance conditions. The performance conditions are based on the UBS return on tangible equity and the divisional return on attributed equity. Certain awards, such as replacement awards issued outside the normal performance year cycle, such as replacement awards or sign-on awards, may take the form of deferred cash under the EOP plan rules.

Notional shares represent a promise to receive UBS shares at vesting and do not carry voting rights during the vesting period. Notional shares granted before February 2014 have no rights to dividends, whereas for awards granted since February 2014 carry a dividend equivalent which may be paid in notional shares or cash and which vests on the same terms and conditions as the awards. Awards are settled by delivering UBS shares at vesting. EOP awards generally vest in equal increments after two and three years following grant. The awards are generally forfeitable upon, among other circumstances, voluntary termination of employment with the Company.

##### **Deferred Contingent Capital Plan (“DCCP”)**

DCCP is a mandatory deferred cash compensation plan for all employees with total compensation above a defined threshold. DCCP awards granted up to January 2015 represent a right to receive a cash payment at vesting. For awards granted since February 2015, DCCP takes the form of notional additional tier 1 (AT1) capital instruments, which may be settled at the discretion of UBS in the form of a cash payment or a marketable AT1 capital instrument. Awards vest in full after five years unless there is a trigger or viability event.

# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **15. Equity Participation and Other Compensation Plans (continued)**

Awards granted under the DCCP are written down if UBS's common equity tier 1 capital ratio falls below defined thresholds. DCCP awards are also forfeited if a viability event occurs, that is if the Swiss Financial Market Supervisory Authority provides a written notice to UBS that the DCCP awards must be written down to prevent an insolvency, bankruptcy or failure of UBS, or if UBS receives a commitment of extraordinary support from the public sector that is necessary to prevent such an event.

For awards granted up to January 2015, interest on the awards is paid annually, provided that UBS achieves an adjusted profit before tax in the preceding year. For awards granted since February 2015, interest payments are discretionary. The awards are generally forfeitable upon, among other circumstances, voluntary termination of employment with the Company.

#### **Equity Plus Plan**

Equity Plus is a voluntary share-based compensation plan that provides eligible employees with the opportunity to purchase shares of UBS at market value and receive one notional UBS share for every three shares purchased, up to a maximum annual limit. Share purchases may be made annually from the performance award and/or monthly through regular deductions from salary. If the shares purchased are held for three years and, in general, if the employee remains in employment, the notional shares vest. For notional shares granted since April 2014, employees are entitled to receive a dividend equivalent which may be paid in notional shares and/or cash.

#### **Financial Advisor Compensation**

The compensation for financial advisors is based on production payout and deferred compensation awards. Production payout, paid monthly in the form of non-deferred cash payments, is primarily based on compensable revenue generated by financial advisors. Financial advisors may also qualify for supplemental compensation in the form of deferred compensation awards, which vest over various time periods of up to ten years depending on the type of award. Production payout rates and deferred compensation awards may be reduced for, among other things, negligence or carelessness, or a failure to comply with the firm's rules, standards, practices and policies or applicable laws and regulations.

Strategic objective awards are deferred compensation awards based on strategic performance measures, including production, length of service with the firm and net new business. These awards are granted in the form of both deferred share-based and deferred cash-based awards with a vesting period of up to 6 years.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **15. Equity Participation and Other Compensation Plans (continued)**

Through performance year 2016, strategic objective awards were partly granted to eligible financial advisors under the PartnerPlus deferred cash plan. In addition to such granted awards (Company contributions), participants were also allowed to voluntarily contribute additional amounts otherwise payable as production payout up to a certain percentage, which vest upon contribution. Company contributions and voluntary contributions are credited with interest in accordance with the terms of the plan. Rather than being credited with interest, a participant may elect to have voluntary contributions, along with vested Company Contributions, credited with notional earnings based on the performance of various mutual funds. Company contributions and interest on both Company and voluntary contributions ratably vest in 20% installments six to ten years following the grant date. Company contributions and interest on notional earnings are forfeitable under certain circumstances.

The Company enters into compensatory arrangements to incentivize certain eligible active financial advisors to achieve specified revenue production and other performance thresholds. Growth Plus is an incentive program for selected financial advisors whose revenue production and length of service exceeds defined thresholds from 2010 through 2017. Compensation arrangements were granted in 2010, 2011, 2015 and 2018. The awards vest ratably over seven years from grant with the exception of the 2018 arrangement which vests over five years.

The Company also enters into compensatory arrangements with certain new financial advisors primarily as a recruitment incentive. The compensation may be earned and paid to the financial advisor during a period of continued employment and may be forfeited under certain circumstances.

In addition to these compensation arrangements, the Company may issue loans to certain new and active financial advisors. As of June 30, 2018, the Company has recorded \$300,037 (net of an allowance of \$25,701) related to these loans which is included in other assets in the consolidated statement of financial condition.

#### **16. Pension and Other Post-Employment Benefit Plans**

##### **Defined Benefit Pension Plan**

Eligible employees of the Company were included in the non-contributory defined benefit pension plan of UBSFSI (the “Plan”), which was frozen in 1998.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **16. Pension and Other Post-Employment Benefit Plans (continued)**

In a previous year, the Plan was amended to offer a permanent lump sum benefit payment feature that allows certain fully vested participants the ability to elect a lump sum benefit payment or to begin receiving annuity payments prior to age 65.

##### *Investment Policies and Strategies*

The equity allocation includes U.S. equities of large, medium and small capitalization companies, international equity and alternative investments. The fixed income allocation includes U.S. long-term fixed income and opportunistic investments in high yield and international fixed income. The Plan's long-term asset allocation target of 30% equity securities, 70% debt securities.

##### *Contributions*

The Company made no contributions to the Plan during the six months ending June 30, 2018. The future contributions to the Plan will be evaluated on a quarterly basis by the Company.

#### **Other Benefit Plans**

Employees of the Company are eligible to participate in the UBS 401(k) Plan or UBS Financial Services Inc. of Puerto Rico Savings Plus Plan, which include an employee savings investment plan and a defined retirement contribution plan.

UBSFSI also provides certain life insurance and health care benefits to employees of the Company. No assets have been segregated and restricted to provide for plan benefits.

#### **17. Income Taxes**

New tax legislation, commonly referred to as the Tax Cuts and Jobs Act (the "Act"), was enacted on December 22, 2017. The Act reduces the corporate income tax rate to 21%, creates a territorial tax system (with a one-time mandatory tax on previously deferred foreign earnings), broadens the tax base and allows for immediate capital expensing of certain qualified property, requires companies to pay minimum taxes on certain foreign earnings and subjects certain payments from corporations to foreign related parties to a minimum tax and limits deductions related to compensation and meals and entertainment.

Given the significance of the legislation, the SEC staff issued Staff Accounting Bulletin No. 118 ("SAB 118"), which allows registrants to record provisional amounts during a one year "measurement period." The measurement period is deemed to end earlier when the registrant



# UBS Financial Services Inc.

## Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

### **17. Income Taxes (continued)**

has obtained, prepared and analyzed the information necessary to finalize its accounting. During the measurement period, impacts of the Act are expected to be recorded at the time a reasonable estimate for all or a portion of the effects can be made, and provisional amounts can be recognized and adjusted as information becomes available, prepared or analyzed. The FASB staff would not object to the application of SAB 118 to private companies. The Company has applied the provisions of SAB 118.

SAB 118 summarizes a three-step process to be applied at each reporting period to account for and qualitatively disclose: (1) the effects of the change in tax law for which accounting is complete; (2) provisional amounts (or adjustments to provisional amounts) for the effects of the tax law where accounting is not complete, but that a reasonable estimate has been determined; and (3) a reasonable estimate cannot yet be made and therefore taxes are reflected in accordance with law prior to the enactment of the Act.

The Act includes commissions and performance based compensation in determining the excessive compensation limitation. This calculation could impact the future deductions related to certain compensation related deferred tax assets. The Company analyzed the deferred assets related to commission and performance based compensation. As the calculation of these deferred tax assets is based on information available at this time and may change upon the issuance of guidance and/or discovery of additional information, the accounting for this matter is provisional.

The Act may have an impact on the calculation of state and local income taxes. As the Company's state and local income tax provision is based on information available at this time and may change upon issuance of guidance and/or discovery of additional information, the accounting for this matter is provisional.

Deferred income taxes reflect the net tax effects of temporary differences between carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

In accordance with ASC Topic 740, if it is more likely than not that the ultimate realization of deferred tax assets is not going to be recognized, a valuation allowance should be recorded. In assessing the recoverability of the deferred tax assets, the Company considered all available positive and negative evidence, including history of earnings, possible tax planning strategies and future taxable income, supported through detailed projections.

After consideration of all relevant evidence, UBSFSI believes that it is more likely than not that a benefit will be realized for federal, state, and local deferred tax assets and accordingly, no valuation allowance was recorded against these assets.

UBS Financial Services Inc.

Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

(Amounts in Thousands of Dollars)

**17. Income Taxes (continued)**

After consideration of all relevant evidence, UBSFSIPR believes that it is more likely than not that a benefit will not be realized for certain foreign deferred tax assets and accordingly, a valuation allowance of \$457,428 has been recorded. Since December 31, 2017, the valuation allowance related to foreign deferred tax assets increased by \$32,915.

The components of the Company's deferred tax assets and liabilities as of June 30, 2018 were as follows:

**Deferred tax assets:**

Employee benefits	\$ 562,270
Net operating loss carryforwards	484,369
Accelerated income and deferred deductions	203,683
Book over tax depreciation	73,459
Valuation of trading assets and investments	4,693
	<u>1,328,474</u>
Valuation allowance	<u>(457,428)</u>
Total deferred tax assets	<u>871,046</u>

**Deferred tax liabilities:**

Accelerated deductions and deferred income	<u>209,633</u>
Total deferred tax liabilities	<u>209,633</u>

Net deferred tax assets	<u>\$ 661,413</u>
-------------------------	-------------------

At June 30, 2018, the Company has federal net operating loss carryforwards of \$633,995 that will begin to expire in 2031, state and local net operating loss carryforwards of \$715,821 that will begin to expire in 2021 and foreign net operating loss carryforwards of \$787,501 that will begin to expire in 2024. The state and local net operating loss carryforwards are primarily related to California, Connecticut, and New York. The Company has foreign tax credit carryforwards of \$13,931 that will begin to expire in 2020.

## UBS Financial Services Inc.

### Notes to Consolidated Statement of Financial Condition (continued)

(Unaudited)

June 30, 2018

*(Amounts in Thousands of Dollars)*

#### **17. Income Taxes (continued)**

UBSFSI is included in the consolidated federal income tax return and certain combined state and local income tax returns of UBS Americas. UBSFSI also files stand-alone returns in various state and local jurisdictions. As of June 30, 2018, the consolidated group, of which UBSFSI is a member, is under examination by the Internal Revenue Service for tax years 2012 through 2014 and tax years 2015 and 2016 are open for examination. There are various state and local jurisdictions currently under audit for tax years 2002 through 2016. UBSFSIPR files income tax returns with the Commonwealth of Puerto Rico, for which tax years 2012 through 2016 are subject to examination.

In the next twelve months, the Company believes there will be no material changes to unrecognized tax benefits.

#### **18. Subsequent Events**

The Company has evaluated its subsequent event disclosure through September 13, 2018, the date that the Company's consolidated statement of financial condition was issued, and has determined that there are no events that would have a material of impact on the consolidated statement of financial condition.