LPL Financial Holdings Inc.
Form 10-Q
July 31, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
(Mark One)

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

For the quarterly period ended June 30, 2013
or

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

For the transition period from to
Commission File Number: 001-34963
LPL Financial Holdings Inc.
(Exact name of registrant as specified in its charter)

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

75 State Street, Boston, MA 02109
(Address of Principal Executive Offices) (Zip Code)

(617) 423-3644
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes x No
The number of shares of Common Stock, par value $0.001 per share, outstanding as of July 17, 2013 was 105,018,375.

TABLE OF CONTENTS

i

WHERE YOU CAN FIND MORE INFORMATION

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

On our internet site, http://www.lpl.com, we post the following filings as soon as reasonably practicable after they are electronically filed with or furnished to the SEC: our annual reports on Form 10-K, our proxy statements, our quarterly reports on Form 10-Q, our current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act. Hard copies of all such filings are available free of charge by request via email (investor.relations@lpl.com), telephone (617) 897-4574, or mail (LPL Financial Investor Relations at 75 State Street, 24th Floor, Boston, MA 02109). The information contained or incorporated on our website is not a part of this Quarterly Report on Form 10-Q.

When we use the terms “LPLFH” “we” “us” “our” the “firm” and the "Company," we mean LPL Financial Holdings Inc., a Delaware corporation, and its consolidated subsidiaries, taken as a whole, unless the context otherwise indicates.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

Statements in Item 2 - “Management's Discussion and Analysis of Financial Condition and Results of Operations” and other sections of this Quarterly Report on Form 10-Q regarding the Company's future financial and operating results, growth, business strategy, plans, liquidity, ability and plans to repurchase shares and pay dividends in the future, including statements regarding projected costs, projected savings, projected expenses and anticipated improvements to the Company's operating model, services, and technology as a result of the Service Value Commitment, as well as any other statements that are not related to present facts or current conditions or that are not purely historical, constitute forward-looking statements. These forward-looking statements are based on the Company's historical performance and its plans, estimates and expectations as of July 31, 2013. The words “anticipates,” “believes,” “expects,” “may,” “plans,” “predicts,” “will” and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. Forward-looking statements are not guarantees that the future results, plans, intentions or expectations expressed or implied by the Company will be achieved. Matters subject to forward-looking statements involve known and unknown risks and uncertainties, including economic, legislative, regulatory, competitive and other factors, which may cause actual financial or operating results, levels of activity, or the timing of events, to be materially different than those expressed or implied by forward-looking statements. Important factors that could cause or contribute to such differences include: changes in general economic and financial market conditions, including retail investor sentiment; fluctuations in the value of assets under custody; effects of competition in the financial services industry; changes in the number of the Company's financial advisors and institutions, and their ability to market effectively financial products and services; changes in interest rates and fees payable by banks participating in the Company's cash sweep program, including the Company's success in negotiating agreements with current or additional counterparties; the Company's success in integrating the operations of acquired businesses; execution of the Company's plans related to the Service Value Commitment, including the Company's ability to successfully transform and transition business processes to third party service providers; the Company's success in negotiating and developing commercial arrangements with third party service providers that will enable the Company to realize the service improvements and efficiencies expected to result from the Service Value Commitment; the performance of third party service providers to which business processes are transitioned from the Company; the Company's ability to control operating risks, information technology systems risks and sourcing risks; the effect of current, pending and future legislation, regulation and regulatory actions, including disciplinary actions imposed by self-regulatory organizations; and the other factors set forth in Part I, “Item 1A. Risk

Factors” in the Company's 2012 Annual Report on Form 10-K. Except as required by law, the Company specifically disclaims any obligation to update any forward-looking statements as a result of developments occurring after the date of this quarterly report, even if its estimates change, and you should not rely on statements contained herein as representing the Company's views as of any date subsequent to the date of this quarterly report.

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Income
(Unaudited)
(Dollars in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
REVENUES:				
Commission	$508,399	$447,243	$993,971	$910,896
Advisory	298,094	268,192	579,320	519,173
Asset-based	107,505	102,784	211,271	200,025
Transaction and other	88,631	78,894	178,009	153,466
Interest income, net of interest expense	4,426	4,800	8,834	9,510
Other	11,865	5,930	22,311	16,546
Total net revenues	1,018,920	907,843	1,993,716	1,809,616
EXPENSES:				
Commission and advisory	701,687	620,582	1,361,240	1,237,974
Compensation and benefits	98,227	93,034	197,007	182,046
Promotional	24,804	26,122	48,469	42,953
Depreciation and amortization	20,245	17,412	40,019	34,587
Occupancy and equipment	16,283	14,007	33,081	28,504
Professional services	14,123	18,199	28,633	31,320
Brokerage, clearing and exchange	11,428	9,554	21,598	19,069
Communications and data processing	10,892	9,797	20,384	18,696
Regulatory fees and other	7,686	6,891	15,105	14,437
Restructuring charges	7,332	2,057	13,369	3,751
Other	10,682	9,441	16,569	16,113
Total operating expenses	923,389	827,096	1,795,474	1,629,450
Non-operating interest expense	12,667	13,439	24,827	29,471
Loss on extinguishment of debt	7,962	—	7,962	16,524
Total expenses	944,018	840,535	1,828,263	1,675,445
INCOME BEFORE PROVISION FOR INCOME TAXES	74,902	67,308	165,453	134,171
PROVISION FOR INCOME TAXES	29,811	27,806	65,645	53,490
NET INCOME	$45,091	$39,502	$99,808	$80,681
EARNINGS PER SHARE (Note 11):				
Basic	$0.42	$0.36	$0.94	$0.73
Diluted	$0.42	$0.35	$0.93	$0.72

See notes to unaudited condensed consolidated financial statements.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income
(Unaudited)
(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
NET INCOME	$45,091	$39,502	$99,808	$80,681
Other comprehensive income, net of tax:				
Adjustment for items reclassified to earnings, net of tax expense of $273 and $527 for the three and six months ended June 30, 2012, respectively	—	441	—	850
Total other comprehensive income, net of tax	—	441	—	850
TOTAL COMPREHENSIVE INCOME	$45,091	$39,943	$99,808	$81,531

See notes to unaudited condensed consolidated financial statements.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Financial Condition
(Unaudited)
(Dollars in thousands, except par value)

	June 30, 2013	December 31, 2012
ASSETS		
Cash and cash equivalents	$584,871	$466,261
Cash and securities segregated under federal and other regulations	440,118	577,433
Receivables from:		
Clients, net of allowance of $521 at June 30, 2013 and $587 at December 31, 2012	306,164	369,814
Product sponsors, broker-dealers and clearing organizations	170,061	152,950
Others, net of allowance of $5,979 at June 30, 2013 and $6,675 at December 31, 2012	248,143	241,324
Securities owned:		
Trading — at fair value	9,049	8,088
Held-to-maturity	8,669	10,202
Securities borrowed	7,556	9,448
Income taxes receivable	—	5,215
Fixed assets, net of accumulated depreciation and amortization of $281,832 at June 30, 2013 and $324,684 at December 31, 2012	138,881	130,847
Debt issuance costs, net of accumulated amortization of $5,604 at June 30, 2013 and $4,903 at December 31, 2012	18,427	21,254
Goodwill	1,371,523	1,371,523
Intangible assets, net of accumulated amortization of $246,823 at June 30, 2013 and $237,681 at December 31, 2012	483,984	503,528
Other assets	136,188	120,637
Total assets	$3,923,634	$3,988,524
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Drafts payable	$155,513	$203,132
Payables to clients	487,798	749,505
Payables to broker-dealers and clearing organizations	23,384	53,031
Accrued commission and advisory expenses payable	130,395	128,459
Accounts payable and accrued liabilities	224,211	216,138
Income taxes payable	2,928	—
Unearned revenue	65,500	61,808
Securities sold, but not yet purchased — at fair value	232	366
Senior secured credit facilities	1,540,515	1,317,825
Deferred income taxes — net	106,658	118,240
Total liabilities	2,737,134	2,848,504
STOCKHOLDERS' EQUITY:		
Common stock, $.001 par value; 600,000,000 shares authorized; 116,513,596 shares issued at June 30, 2013 and 115,713,741 shares issued at December 31, 2012	116	116
Additional paid-in capital	1,260,977	1,228,075
Treasury stock, at cost — 10,994,785 shares at June 30, 2013 and 9,421,800 shares at December 31, 2012	(345,388)	(287,998)

Retained earnings	270,795	199,827
Total stockholders’ equity	1,186,500	1,140,020
Total liabilities and stockholders’ equity	$3,923,634	$3,988,524

See notes to unaudited condensed consolidated financial statements.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Stockholders' Equity
(Unaudited)
(Amounts in thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Treasury Stock Shares	Treasury Stock Amount	Accumulated Other Comprehensive Loss	Retained Earnings	Total Stockholders' Equity
BALANCE — December 31, 2011	110,532	$110	$1,137,723	2,618	$(89,037)	$(850)	$296,802	$1,344,748
Net income and other comprehensive income, net of tax expense						850	80,681	81,531
Issuance of common stock to settle restricted stock units	2,823	3	(3)					—
Treasury stock purchases				1,705	(55,894)			(55,894)
Cash dividends on common stock							(222,557)	(222,557)
Stock option exercises and other	1,952	2	11,097					11,099
Share-based compensation	22		12,072					12,072
Excess tax benefits from share-based compensation			48,404					48,404
BALANCE — June 30, 2012	115,329	$115	$1,209,293	4,323	$(144,931)	$—	$154,926	$1,219,403
BALANCE — December 31, 2012	115,714	$116	$1,228,075	9,422	$(287,998)	$—	$199,827	$1,140,020
Net income and other comprehensive income, net of tax expense							99,808	99,808
Treasury stock purchases				1,584	(57,770)			(57,770)
Cash dividends on common stock							(28,763)	(28,763)
Stock option exercises and other	800		17,996	(11)	380		(77)	18,299
Share-based compensation			12,693					12,693
Excess tax benefits from share-based compensation			2,213					2,213

BALANCE — June 30, 2013	116,514	$116	$1,260,977	10,995	$(345,388)	$—	$270,795	$1,186,500

See notes to unaudited condensed consolidated financial statements.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

	Six Months Ended June 30, 2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$99,808	$80,681
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Noncash items:		
Depreciation and amortization	40,019	34,587
Amortization of debt issuance costs	2,219	2,349
Share-based compensation	12,693	12,072
Excess tax benefits related to share-based compensation	(2,213)	(48,404)
Provision for bad debts	575	488
Deferred income tax provision	(11,582)	(6,241)
Loss on extinguishment of debt	7,962	16,524
Net changes in estimated fair value of contingent consideration obligations	1,203	709
Other	1,252	1,519
Changes in operating assets and liabilities:		
Cash and securities segregated under federal and other regulations	137,315	60,968
Receivables from clients	63,716	8,405
Receivables from product sponsors, broker-dealers and clearing organizations	(17,111)	11,844
Receivables from others	(8,127)	(10,806)
Securities owned	(1,089)	(574)
Securities borrowed	1,892	(2,238)
Other assets	(12,101)	(41,215)
Drafts payable	(47,619)	(37,645)
Payables to clients	(261,707)	(51,859)
Payables to broker-dealers and clearing organizations	(29,647)	898
Accrued commission and advisory expenses payable	1,936	(11,747)
Accounts payable and accrued liabilities	2,348	(3,874)
Income taxes receivable/payable	10,356	40,592
Unearned revenue	3,692	(759)
Securities sold, but not yet purchased	(134)	(161)
Net cash (used in) provided by operating activities	$(4,344)	$56,113

Continued on following page

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows - Continued
(Unaudited)
(Dollars in thousands)

	Six Months Ended June 30, 2013	2012
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	$(32,161)	$(18,793)
Purchase of securities classified as held-to-maturity	(2,495)	(2,015)
Proceeds from maturity of securities classified as held-to-maturity	4,000	3,000
Deposits of restricted cash	(1,500)	(9,964)
Release of restricted cash	—	6,800
Acquisitions, net of cash acquired	—	(38,766)
Purchases of minority interest investments	(1,000)	—
Net cash used in investing activities	(33,156)	(59,738)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of senior secured credit facilities	(861,160)	(1,343,393)
Proceeds from senior secured credit facilities	1,078,957	1,330,681
Payment of debt issuance costs	(2,461)	(4,431)
Repurchase of common stock	(50,975)	(55,894)
Dividends on common stock	(28,763)	(222,557)
Excess tax benefits related to share-based compensation	2,213	48,404
Proceeds from stock option exercises and other	18,299	11,099
Net cash provided by (used in) financing activities	156,110	(236,091)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	118,610	(239,716)
CASH AND CASH EQUIVALENTS — Beginning of period	466,261	720,772
CASH AND CASH EQUIVALENTS — End of period	$584,871	$481,056
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid	$24,779	$29,570
Income taxes paid	$66,466	$17,765
NONCASH DISCLOSURES:		
Fixed assets acquired under build-to-suit lease	$—	$5,599
Gain on interest rate swaps, net of tax expense	$—	$850
Discount on proceeds from senior secured credit facilities recorded as debt issuance costs	$4,893	$19,319
Pending settlement of treasury stock purchases	$6,795	$—

See notes to unaudited condensed consolidated financial statements.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Organization and Description of the Company

LPL Financial Holdings Inc. ("LPLFH"), a Delaware holding corporation, together with its consolidated subsidiaries (collectively, the "Company") provides an integrated platform of brokerage and investment advisory services to independent financial advisors and financial advisors at financial institutions (collectively "advisors") in the United States of America. Through its custody and clearing platform, using both proprietary and third-party technology, the Company provides access to diversified financial products and services enabling its advisors to offer independent financial advice and brokerage services to retail investors (their "clients").

2. Summary of Significant Accounting Policies

Basis of Presentation — Quarterly Reporting — The unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These unaudited condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. These adjustments are of a normal recurring nature. The Company's results for any interim period are not necessarily indicative of results for a full year or any other interim period. Certain reclassifications were made to previously reported amounts in the unaudited condensed consolidated financial statements and notes thereto to make them consistent with the current period presentation.

The unaudited condensed consolidated financial statements do not include all information and notes necessary for a complete presentation of financial position, results of income, comprehensive income and cash flows in conformity with generally accepted accounting principles in the United States of America ("GAAP"). Accordingly, these financial statements should be read in conjunction with the Company's audited consolidated financial statements and the related notes for the year ended December 31, 2012, contained in the Company's Annual Report on Form 10-K as filed with the SEC. The Company has evaluated subsequent events up to and including the date these unaudited condensed consolidated financial statements were issued.

Consolidation — These unaudited condensed consolidated financial statements include the accounts of LPLFH and its subsidiaries. Intercompany transactions and balances have been eliminated. Equity investments in which the Company exercises significant influence but does not exercise control and is not the primary beneficiary are accounted for using the equity method.

Comprehensive Income — The Company presents its unaudited condensed consolidated statements of comprehensive income separately and immediately following its unaudited condensed consolidated statements of income. The Company's comprehensive income is composed of net income and the effective portion of the gains on financial derivatives in cash flow hedge relationships, net of related tax effects.

Use of Estimates — The preparation of the unaudited condensed consolidated financial statements in conformity with GAAP requires the Company to make estimates and judgments that affect the reported amounts of assets and liabilities, revenue and expenses and related disclosures of contingent assets and liabilities. On an on-going basis, the Company evaluates estimates, including those related to revenue and related expense recognition, asset impairment, valuation of accounts receivable, valuation of financial instruments, contingent consideration obligations, contingencies and litigation, valuation and recognition of share-based payments, dividends and income taxes. These accounting policies are stated in the notes to the audited consolidated financial statements for the year ended December 31, 2012, contained in the Annual Report on Form 10-K as filed with the SEC. These estimates are based on the information that is currently available and on various other assumptions that the Company believes to be reasonable under the circumstances. Actual results could vary from these estimates under different assumptions or conditions and the differences may be material to the unaudited condensed consolidated financial statements.

Reportable Segment — The Company's internal reporting is organized into three service channels; Independent Advisor Services, Institution Services and Custom Clearing Services. These service channels qualify as individual operating

segments, but are aggregated and viewed as one single reportable segment due to their similar economic characteristics, products and services, production and distribution process, regulatory environment and quantitative thresholds.
Fair Value of Financial Instruments — The Company’s financial assets and liabilities are carried at fair value or at amounts that, because of their short-term nature, approximate current fair value, with the exception of its

indebtedness. The Company carries its indebtedness at amortized cost. The Company measures the implied fair value of its debt instruments using trading levels obtained from a third-party service provider. Accordingly, the debt instruments would qualify as Level 2 fair value measurements. See Note 4 for additional detail regarding the Company’s fair value measurements. As of June 30, 2013, the carrying amount and fair value of the Company’s indebtedness was approximately $1,540.5 million and $1,534.2 million, respectively. As of December 31, 2012, the carrying amount and fair value was approximately $1,317.8 million and $1,320.4 million, respectively.

Contingent Consideration — The Company may be required to pay future consideration to the former shareholders of acquired companies, depending upon the terms of the applicable purchase agreement, that is contingent upon the achievement of certain financial or operating targets. The fair value of the contingent consideration is determined using financial forecasts and other estimates, which assess the probability and timing of the financial targets being reached, and measuring the associated cash payments at their present value using a risk-adjusted rate of return. The estimated fair value of the contingent consideration on the acquisition date is included in the purchase price of the acquired company. At each reporting date, or whenever there are significant changes in underlying key assumptions, a review of these assumptions is performed and the contingent consideration liability is updated to its estimated fair value. If there are no significant changes in the assumptions, the quarterly determination of the fair value of contingent consideration reflects the implied interest for the passage of time. Changes in the estimated fair value of the contingent consideration obligations may result from changes in the terms of the contingent payments, changes in discount periods and rates, changes in assumptions with respect to the timing and likelihood of achieving the applicable targets and other related developments. Actual progress toward achieving the financial targets for the remaining measurement periods may be different than the Company's expectations of future performance. The change in the estimated fair value of contingent consideration has been classified as other expenses in the unaudited condensed consolidated statements of income.

Recently Issued Accounting Pronouncements — There were no recently issued accounting pronouncements or changes in accounting pronouncements during the six months ended June 30, 2013, as compared to the recent accounting pronouncements described in the Company's 2012 Annual Report on Form 10-K, that are of significance, or potential significance, to the Company.

3. Restructuring

Service Value Commitment

On February 5, 2013, the Company committed to an expansion of its Service Value Commitment, an ongoing effort to position the Company for sustainable long-term growth by improving the service experience of its advisors and delivering efficiencies in its operating model. The Company has assessed its information technology delivery, governance, organization and strategy and committed to undertake a course of action (the “Program”) to reposition its labor force and invest in technology, human capital, marketing and other key areas to enable future growth. The Program is expected to be completed in 2015.

The Company estimates total charges in connection with the Program to be approximately $65.0 million. These expenditures are comprised of outsourcing and other related costs, technology transformation costs, employee severance obligations and other related costs and non-cash charges for impairment of certain fixed assets related to internally developed software.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)

The following table summarizes the balance of accrued expenses and the changes in the accrued amounts for the Program as of and for the six months ended June 30, 2013 (in thousands):

	Accrued Balance at December 31, 2012	Costs Incurred(1)	Payments	Non-cash	Accrued Balance at June 30, 2013	Total Expected Restructuring Costs(2)
Outsourcing and other related costs	$—	$6,495	$(5,786)	$—	$709	$26,000
Technology transformation costs	—	3,200	(2,946)	—	254	23,000
Employee severance obligations and other related costs	—	1,555	(787)	—	768	15,000
Asset impairments (Note 4)	—	842	—	(842)	—	1,000
Total	$—	$12,092	$(9,519)	$(842)	$1,731	$65,000

(1) At June 30, 2013, costs incurred represent the total cumulative costs incurred under the Program to date.

(2) At June 30, 2013, total expected restructuring costs exclude approximately $25.0 million of internally developed software and computer and networking equipment related to the Program that is expected to be capitalized with a useful life ranging from three to seven years, and with expense being recorded as depreciation and amortization within the unaudited condensed consolidated statements of income. As of June 30, 2013, approximately $11.4 million has been spent on technology infrastructure of which approximately $8.2 million has been capitalized, with the remainder included in costs incurred.

4. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. Inputs used to measure fair value are prioritized within a three-level fair value hierarchy. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 — Quoted prices in active markets for identical assets or liabilities.
- Level 2 — Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

There have been no transfers of assets or liabilities between fair value measurement classifications during the six months ended June 30, 2013.

The Company’s fair value measurements are evaluated within the fair value hierarchy, based on the nature of inputs used to determine the fair value at the measurement date. At June 30, 2013, the Company had the following financial assets and liabilities that are measured at fair value on a recurring basis:

Cash Equivalents — The Company’s cash equivalents include money market funds, which are short term in nature with readily determinable values derived from active markets.

Securities Owned and Securities Sold, But Not Yet Purchased — The Company's trading securities consist of house account model portfolios for the purpose of benchmarking the performance of its fee based advisory platforms and temporary positions resulting from the processing of client transactions. Examples of these securities include money market funds, U.S. treasury obligations, mutual funds, certificates of deposit and traded equity and debt securities. The Company uses prices obtained from independent third-party pricing services to measure the fair value of its trading securities. Prices received from the pricing services are validated using various methods including comparison to prices received from additional pricing services, comparison to available quoted market prices and review of other relevant market data including implied yields of major categories of securities. In general, these

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)

quoted prices are derived from active markets for identical assets or liabilities. When quoted prices in active markets for identical assets and liabilities are not available, the quoted prices are based on similar assets and liabilities or inputs other than the quoted prices that are observable, either directly or indirectly. For certificates of deposit and treasury securities, the Company utilizes market-based inputs including observable market interest rates that correspond to the remaining maturities or the next interest reset dates. At June 30, 2013, the Company did not adjust prices received from the independent third-party pricing services.

Other Assets — The Company’s other assets include deferred compensation plan assets that are invested in money market and other mutual funds which are actively traded and valued based on quoted market prices, and certain non-traded real estate investment trusts with quoted prices for identical or similar securities and other inputs that are observable or can be corroborated by observable market data.

Contingent Consideration Liabilities — The contingent consideration liabilities, which are included in accounts payable and accrued liabilities in the unaudited condensed consolidated statements of financial condition, result from the Company's acquisitions of National Retirement Partners, Inc. ("NRP"), Concord Capital Partners ("Concord") and Veritat Advisors, Inc. ("Veritat").

The following table summarizes the Company’s financial assets and financial liabilities measured at fair value on a recurring basis at June 30, 2013 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value Measurements
At June 30, 2013:				
Assets				
Cash equivalents	$333,495	$—	$—	$333,495
Securities owned — trading:				
Money market funds	409	—	—	409
Mutual funds	6,229	—	—	6,229
Equity securities	118	—	—	118
Debt securities	—	787	—	787
U.S. treasury obligations	1,506	—	—	1,506
Total securities owned — trading	8,262	787	—	9,049
Other assets	39,398	1,091	—	40,489
Total assets at fair value	$381,155	$1,878	$—	$383,033
Liabilities				
Securities sold, but not yet purchased:				
Mutual funds	$9	$—	$—	$9
Equity securities	130	—	—	130
Debt securities	—	48	—	48
Certificates of deposit	—	45	—	45
Total securities sold, but not yet purchased	139	93	—	232
Contingent consideration obligations	—	—	37,090	37,090
Total liabilities at fair value	$139	$93	$37,090	$37,322

Certain assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value measurement in certain circumstances, for example, when evidence of impairment exists. During the six months ended June 30, 2013, the Company recorded an asset impairment charge of $0.8 million for certain fixed assets related to internally developed software that were determined to have no estimated fair value (See Note 3). The Company has determined that the impairment qualifies as a non-recurring Level 3 measurement under the fair value hierarchy.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)

The following table summarizes the Company’s financial assets and financial liabilities measured at fair value on a recurring basis at December 31, 2012 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value Measurements
At December 31, 2012:				
Assets				
Cash equivalents	$177,393	$—	$—	$177,393
Securities owned — trading:				
Money market funds	302	—	—	302
Mutual funds	5,737	—	—	5,737
Equity securities	414	—	—	414
Debt securities	—	235	—	235
U.S. treasury obligations	1,400	—	—	1,400
Total securities owned — trading	7,853	235	—	8,088
Other assets	28,624	—	—	28,624
Total assets at fair value	$213,870	$235	$—	$214,105
Liabilities				
Securities sold, but not yet purchased:				
Mutual funds	$38	$—	$—	$38
Equity securities	247	—	—	247
Debt securities	—	55	—	55
Certificates of deposit	—	26	—	26
Total securities sold, but not yet purchased	285	81	—	366
Contingent consideration obligations	—	—	35,887	35,887
Total liabilities at fair value	$285	$81	$35,887	$36,253

Changes in Level 3 Recurring Fair Value Measurements

The table below provides information on the valuation technique, significant unobservable inputs and the ranges utilized by the Company in measuring fair value on a recurring basis of the significant Level 3 liabilities as of June 30, 2013 (dollars in millions):

	Fair Value	Valuation Technique	Unobservable Input	Range
Contingent consideration obligations	$37.1	Probability weighted discounted cash flow	Discount rate	3% - 13%

The Company determines the fair value for its contingent consideration obligations using an income approach whereby the Company assesses the probability and timing of the achievement of the applicable milestones, which are based on contractually negotiated financial or operating targets that vary by acquisition transaction, such as revenues, gross margin, EBITDA and assets under custody. The contingent payments are estimated using a probability weighted, multi-scenario analysis of expected future performance of the acquired businesses. The Company then discounts these expected payment amounts to calculate the fair value as of the valuation date. The Company's management evaluates the underlying projections and other related factors used in determining fair value each period and makes updates when there have been significant changes in management's expectations.

The principal significant unobservable input used in the valuations of the Company's contingent consideration obligations is a risk-adjusted discount rate. Whereas management's underlying projections adjust for market penetration and adoption rates, the discount rate is risk-adjusted for key factors such as advisor attrition, advisor recruitment, expenses and overhead costs, average client assets, revenue generation of client assets and credit risk. An increase in the discount rate will result in a decrease in the fair value of contingent consideration. Conversely, a decrease in the discount rate will result in an increase in the fair value of contingent consideration.

The contingent consideration obligation related to the acquisition of NRP is based on the achievement of certain revenue-based targets for the year ending December 31, 2013 (the "Performance Measurement Period"), in aggregate for those advisors joining LPL Financial LLC ("LPL Financial") subsequent to the NRP acquisition for whom retirement plans comprise a significant part of their business. During the first six months of 2013, as a result of greater than expected recruitment of new advisors who serve retirement plans, which is expected to continue throughout the Performance Measurement Period, the Company revised its revenue estimates and made certain changes in the probability assumptions with respect to the likelihood of achieving the revenue targets. These revisions, combined with implied interest, resulted in a $4.7 million increase in the fair value of the contingent consideration obligation related to NRP during the six months ended June 30, 2013 which is recorded in other expenses in the unaudited condensed consolidated statements of income.

The contingent consideration obligation related to the acquisition of Concord is based on the achievement of targeted levels of gross margin attributed to Concord for the year ending December 31, 2013. Gross margin is calculated as net revenues less production expenses and accordingly, the Company considers gross margin to be a non-GAAP measure. Net revenue includes revenues attributed to Concord's business activities and assets under administration on Concord's software platform. Production expenses include all expenses directly incurred to generate net revenues, including commission and advisory expense and brokerage, clearing and exchange expense. During the first quarter of 2013, the Company revised its estimates of the amount and timing of projected 2013 gross margin and adjusted its assumptions regarding the likelihood of payment. The revisions resulted in a $3.8 million decrease in the fair value of the contingent consideration obligation related to Concord during the six months ended June 30, 2013 which is recorded in other expenses in the unaudited condensed consolidated statements of income. The maximum amount of contingent consideration is $15.0 million.

The contingent consideration obligation related to the acquisition of Veritat is based on the achievement of targeted levels of assets under management and earnings, as well as, the retention of key employees. The majority of the contingent consideration is based on a sliding scale of the financial targets of assets under management and earnings. Financial forecasts are used by management that include assumptions about growth in assets under management, earnings, employee retention and discount rates in order to assist with determining the progress toward these targets. The financial targets are sensitive to advisor recruitment, market fluctuations and the ability of advisors to grow their business. The Company maintained its original estimate for the contingent consideration obligation related to Veritat and therefore recorded implied interest of $0.3 million in other expenses in the unaudited condensed consolidated statements of income during the six months ended June 30, 2013.

Set forth below is a reconciliation of the contingent consideration for the six months ended June 30, 2013 (in thousands):

Fair value at December 31, 2012	$35,887
Net changes in estimated fair value of contingent consideration obligations	1,203
Fair value at June 30, 2013	$37,090

5. Held-to-Maturity Securities

The Company holds certain investments in securities including U.S. government notes, which are recorded at amortized cost because the Company has both the intent and the ability to hold these investments to maturity. Interest income is accrued as earned. Premiums and discounts are amortized using a method that approximates the effective yield method over the term of the security and are recorded as an adjustment to the investment yield. The Company discloses the fair value of its securities held-to-maturity using quoted prices in active markets, which is a Level 1 fair value measurement.

LPL FINANCIAL HOLDINGS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)

The amortized cost, gross unrealized loss or gain and fair value of securities held-to-maturity were as follows (in thousands):